Heckerling Musings 2023 and Estate Planning Current Developments

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April 12, 2023

Important Information Regarding This Summary

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

Introduction

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

1. Summary of Top Developments in 2022

Ron Aucutt (Lakewood Ranch, Florida) lists the following as his top ten developments in 2022 in his report, "Top Ten" Estate Planning and Estate Tax Developments of 2022 (January 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**:

(1) Estate Tax Deduction: Present Value Concepts (Prop. Regs.) (see Item 7 below);

(2) Clarification of SECURE Act RMD Rules (Prop. Reg. §1.401(a)(9)-4, Notice 2022-53) (see Item 4.f(4) below);

(3) IRS Funding in the "Inflation Reduction Act": Public and Political Perceptions (see Item 2.c below);

(4) Other Changes and Challenges in the Components of Valuation (Interest Rates, Actuarial Tables [see Item 8 below], *Wandry* Settlement-*Sorensen* [see Item 14 below];

(5) Disqualification of a GRAT Over Valuation Process (CCA 202152018, *Baty*) (see Items 23 and 24 below);

(6) Courts Back Off from Allowing Arbitration (*Boyle* (Va), *Hekemian* (NJ);

(7) IRS Rulemaking and the Example of Syndicated Conservation Easements (see Item 21 below);

(8) Proposed Exceptions from Anti-Clawback Rules (Prop. Reg. §20.2010-1(c)(3)) (see Item 6 below);

(9) "Sprinkling" CRUTs (CCA 202233014) (see Item 28 below); and

(10) Intergenerational split-dollar life insurance (*Estate of* Levine) (see Item 20.b below).

2. Legislative Developments

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

The FY24 Greenbook proposals have precious **little chance of being enacted** into law with a split Congress. Ron Aucutt warns "Even so, whenever we see legislative proposals articulated like this, it is important to pay attention, because they are constantly evolving and could be pulled from the shelf and enacted, if not this year then in the future when the political climate is different. Such proposals never completely go away. And each time they are refined and updated, we can learn more about what to watch for and how to react."

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

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

(2) **Taxation of Individuals.**

- Increase the top marginal income tax rate from 37% to 39.6%
- Tax the capital income for high-income earners (taxable income over $1 million, $500,000 for married filing separately, both indexed) at ordinary rates
- The net investment income tax rate would increase from 3.8% to 5.0% for taxpayers with more than $400,000 of earnings (indexed) (new in FY24 Greenbook) and the net investment income tax would be applied to pass-through business income for high income taxpayers (in the FY23 and FY24 Greenbooks)
- The 39.6% top marginal income tax rate and the 5% net investment income tax rate bring the top marginal rate to 44.6%
- The Medicare tax would increase from 3.8% to 5.0% for taxpayers with more than $400,000 of earnings (indexed) (new in FY24 Greenbook)
- Treat transfers of appreciated property by gift or on death as realization events; gain on unrealized appreciation also would be recognized by every trust, partnership or other non-corporate entity if the property has been held on or after January 1, 1942 and has not been the subject of a recognition event within 90 years; the FY24 Greenbook clarifies that the first such deemed recognition event would occur on December 31, 2032
- Impose a 25% (up from 20% in the FY23 Greenbook) minimum tax on the income (generally including unrealized gains) on wealthiest taxpayers (similar to what has been referred to as the "Billionaire Income Tax" proposals; for a discussion of these similar proposals see Item 2.1 and 2.m of Estate Planning Current Developments and Hot Topics 2022 (December 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**)
- Taxing "carried interests" as ordinary income
- Eliminating real estate like-kind exchanges for gains in excess of $500,000 ($1 million for joint returns) (not indexed)

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

- Add additional restrictions on GRATs (including a 10-year minimum term and a 25% remainder interest-which would effectively kill the use of GRATs going forward)
- Recognize gain on sale transactions with grantor trusts (with an effective date for *transactions* after the date of enactment)
- Treat the payment of income tax by the grantor on grantor trust income as a gift (effective for trusts created after the date of enactment)
- Provide consistent valuation of promissory notes at death
- Limit the duration of GST exemption (distributions to generations younger than grandchildren or persons alive on the date of creation would be subject to the GST tax, and existing trusts would be treated as being created on the date of enactment)
- Expand the definition of executor for all tax purposes (an example of the significance of this proposal is *Sander v. Commissioner*, T.C. Memo. 2022-103, which held that the trustee of the decedent's revocable trust was not a proper party to contest assessed income tax deficiencies of the decedent)
- Increase the special use valuation value reduction from $750,000 (indexed) to $11.7 million ($13 million in the FY24 Greenbook)
- Extend the 10-year estate and gift tax lien

- Require reporting (not specified as to how detailed the reporting will be) of the estimated value of trust assets for trusts valued over $300,000 or with gross income over $10,000 (the FY24 Greenbook adds that both of these amounts are indexed after 2024); The FY24 Greenbook adds the each trust would have to report on its annual income tax return "the inclusion ratio of the trust at the time of any trust distribution to a non-skip person, as well as information regarding any trust modification or transaction with another trust that occurred during that year"; this information is described as providing information for a comprehensive statistical data base about trusts rather than for targeting trust audits, but the reporting could be very burdensome and, for many, quite ominous; applicable to taxable years ending after the date of enactment
- Not included: reducing the estate and gift tax exclusion amount prior to 2026 or including grantor trust assets in the grantor's gross estate under §2901

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

- Defined value formula clauses to determine the value of gifts or bequests that depend on some activity of the IRS will not be recognized, other than a formula clause defining a marital or exemption equivalent bequest at death based on the decedent's remaining transfer tax exclusion amount
  - Reasons given for the proposal are (i) the clauses allow donors to escape gift taxes for undervaluing transfers, (ii) the clauses make gift tax return examinations and litigation cost-ineffective, (iii) transferred property must be reallocated among donees long after the gift, and (iv) the property rights of donees are determined in a tax valuation process in which they cannot participate
  - The proposal literally says "the value of such gift or bequest will be deemed to be the value as reported on the corresponding gift or estate tax return"; wouldn't donors love having the reported value being automatically accepted as the final value? – that obviously is not intended but presumably the quantity of the transfer (number or percentage of shares or units) would be deemed to be the quantity estimated on the return
  - Clauses with a formula based on an appraisal within a reasonably short period of time (as in *Nelson v. Commissioner*) would be recognized (even if the appraisal is "after the due date of the return")
  - This proposal also appears to target inter vivos or testamentary charitable lead annuity trusts (CLATs) that define the charitable annuity amount by a formula to reduce the remainder to zero or some specified value
  - The proposal is effective for transfers by gift or at death after 2023
- "Simplify" the exclusion from gift tax for annual gifts; this proposal would limit the annual exclusion for many types of gifts to $50,000 per donor; this is similar to prior proposals from the Clinton and Obama administrations as well as a proposal in section 10 of Senator Sanders' "For the 99.5 Percent Act"; the proposal is effective for gifts after 2023
- Several proposals impact GST tax issues:
  - A purchase of assets from a GST non-exempt trust or any other property subject to GST tax would be treated as an addition to trust principal requiring a redetermination of the purchasing trust's inclusion ratio (by adding the purchased assets to the denominator of the applicable fraction); the proposal would also apply to a decanting transaction (presumably from a non-exempt trust); effective for transactions occurring after the date of enactment
  - Under current law, charitable entities are treated as assigned to the transferor's generation under §2651(f)(3) and §501(c)(3) charities are not counted as having an

interest in the trust for purposes of delaying a taxable termination (§2652(c)(1)(B)); the proposal is also to exclude §501(c)(4)s (and other designated exempt organizations) as having an interest in the trust for that purpose

    - Loans from a trust to a beneficiary will be treated as a distribution for GST tax purposes and a refund of GST tax paid as a result of such deemed distribution can be requested within one year after the loan is repaid in full; furthermore repayment of a loan to the grantor or deemed owner of a trust would be treated as a new contribution to the trust for GST tax purposes; the proposal applies to loans made, renegotiated, or renewed by trusts after the year of enactment

- As part of the loan proposal described immediately above, loans from a trust to a beneficiary would be treated as a distribution for purposes of carrying out DNI to the borrowing beneficiary; the loan provision (including the GST tax provisions described above) apparently apply to loans of property as well as cash loans because the proposal says the IRS may by regulations except certain loans such as short-term loans or the use of real or tangible property for a minimal number of days
- Section 2704(b) would be repealed (the good news), to be replaced (the bad news) by a provision generally treating the value of transfers of a partial interest in non-publicly traded property to or for a family member as a pro rata portion of the collective FMV of all interests held by the transferor and family members (with a broad definition of family including the transferor's ancestors and descendants and their spouses)
    - For transfers involving a trade or business, passive assets would be segregated and "the FMV of the family's collective interest would be the sum of the FMV of the interest allocable to a trade or business (not including its passive assets), and the FMV of the passive assets allocable to the family's collective interest determined as if the passive assets were held directly by a sole individual"
    - This special valuation rule would apply only if the family collectively owns at least 25% of the whole (and a special rule in footnote 41 applies for making that determination)
    - Despite a statement in the FY24 Greenbook that "discounts for lack of marketability and lack of control … are not appropriate when families are acting in concert to maximize their economic benefits," under the proposal, a lack of marketability discount presumably would apply in valuing the family's collective interest in a trade or business (even if the family owns a majority interest) and a lack of control discount would apply if the family's collective interest is not a controlling interest
    - The valuation proposal would apply to valuations as of a valuation date on or after the date of enactment
- Charitable lead annuity trusts (CLATs) would have to include a fixed level annuity amount over the trust term, and the remainder interest at the creation of the CLAT would have to be at least 10% of the value of the property used to fund the CLAT (no more "zeroed-out" CLATs); effective for all CLATs created after date of enactment

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

- Limit the use of donor advised funds (DAFs) to avoid the private foundation annual 5% payout requirement (i.e., distributions from a private foundation to a DAF would not be a qualifying distribution unless the DAF makes a qualifying distribution of those funds by the end of the following taxable year, and the FY24 Greenbook adds that a qualifying distribution under this exception does not include a distribution to another DAF); this is different from additional restrictions that would be imposed on DAFs and private foundations generally under the Accelerating Charitable Efforts (ACE) Act introduced in the House and Senate (H.R. 6595 and S. 1981) in 2021 and 2022

- Private foundation payments to disqualified persons (other than a foundation manager who is not a family member of any substantial contributor) for compensation or expense reimbursement would not satisfy the annual 5% payout requirement for foundations, but they would still qualify for the exception from self-dealing if the payments are reasonable and necessary to carry out the foundation's exempt purposes (new in FY24 Greenbook)

(6) **Retirement Plan Issues.**

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

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

- Medicare would be allowed to negotiate drug prices on some drugs over a period of years; out-of-pocket drug costs of seniors enrolled in Part D of Medicare would be capped at $2,000 per year; a provision imposing an inflation cap on prescription drug prices was dropped from the reconciliation package by the Senate parliamentarian (which eliminated about $100 billion of potential savings and deficit reduction, paid for by extending pass-through loss limitations for two years). Medicare savings will be used to pay for three years of subsidized Obamacare premiums.
- Various climate change and energy provisions include about $369 billion spending (including expanded tax credits) with requirements that electric vehicles must be built in North America to qualify for tax credits. These provisions are estimated to lower energy costs and reduce carbon emissions by roughly 40 percent from a 2005 baseline by 2030.
- Over $300 billion of deficit reduction would result over ten years.
- Revenue raisers include (1) a 15% corporate minimum tax on companies with average financial statement income (i.e., book income) over $1 billion (which was modified to allow applicable companies to include accelerated tax depreciation, including bonus depreciation, in computing book income and to eliminate certain common control aggregation rules for portfolio companies (which generally benefits many private-equity owned businesses); (2) a 1% stock buyback tax for §317(b) stock redemptions or similar transactions for publicly traded corporations (applicable for stock repurchases after December 31, 2022); and (3) an $80 billion boost to the IRS for enforcement and operations enhancements. The Joint Committee on Taxation projects that corporations will pay an additional $222.2 billion over ten years from the new corporate minimum tax and will pay $73.7 billion over ten years from the 1% excise tax on stock buybacks. Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions of Title I – Committee On Finance, Of An Amendment In The Nature Of A Substitute To H.R. 5376, "An Act To Provide For Reconciliation Pursuant To Title II Of S. Con. Res. 14," As Passed By The Senate On August 7, 2022, And Scheduled For Consideration.by the House of Representatives on August 12, 2022, JCX-18-22 (August 9, 2022).
- **The Act does not otherwise reverse the 2017 tax cuts (including the lower corporate rate), impose additional taxes on high earners (such as the 5% and 8% surtax), eliminate the carried interest tax break, or include any provisions affecting transfer taxes or taxing unrecognized gains.**

- Notice 2023-7, issued December 27, 2022, announces the IRS's intention to issue proposed regulations addressing the new 15% corporate minimum tax, and provides interim guidance regarding various time-sensitive issues that will be addressed in the proposed regulations. Notice 2023-20, issued on February 17, 2023, provides additional interim guidance "to help avoid substantial unintended adverse consequences to the insurance industry."
- Notice 2023-2, issued December 27, 2022, provides guidance regarding the 1% excise tax on stock redemptions, including an exclusive list of §317(b) redemption transactions that are not treated as repurchases and guidelines for determining the fair market value of stock that is repurchased.
- The $80 billion of additional IRS funding for enforcement, taxpayer services, operations support and modernization has been controversial. The additional IRS funding is discussed in Item 2.c immediately below.
- A collateral effect of the legislation is that extending the qualified business income deduction past 2025 is made more difficult. A provision that had been considered as a revenue offset to extend the §199A QBI deduction was an extension of the cap on excess business losses, but that provision was used to offset the cost of modifications in the Senate to the 15% tax on book income of large corporations. Doug Sword, *Section 199A Extension Just Got Tougher to Cover*, TAX NOTES TODAY FEDERAL (August 9, 2022).
- Democrats have been praising the legislation as the most significant legislation ever impacting climate change, as legislation to reduce drug prices and extend Obamacare subsidies, and as providing much needed additional resources to the IRS to increase tax collections.
- For a discussion of the 15% corporate minimum tax on book income, see Michael Geeraerts & Jim Magner, *What Advisors Need to Know About the New Book Income AMT, Including COLI's Impact on EBITDA and E&P*, LEIMBERG BUSINESS ENTITIES NEWSLETTER #255 (August 23, 2022).

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

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

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

> The IRS has a lot of ground to make up on audits. The agency scaled back audits of all taxpayers between 2010 and 2019, with the total audit rate falling to 0.25% from 0.9%. The largest drop has been among those reporting $5 million or more, who have a 2.35% chance of being audited, down from more than 16% a decade ago, according to a May watchdog report from the Government Accountability Office.
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> IRS Commissioner Chuck Rettig said in a **letter** to Congress on Thursday that the agency has fewer auditors in the field at any time since World War II, underscoring the need for the additional money. Rettig told a House panel earlier this year that his agency is "outgunned" in examinations of large companies that have teams of corporate accountants and lawyers. Laura Davison, *Wealthy Americans Escape Tax Hikes But Would Face Beefed-Up IRS*, BLOOMBERG DAILY TAX REPORT (August 5, 2022).

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

> The world has become more complex. Enforcing tax laws is not as simple as it was a few decades ago. Average tax returns for large corporations now reach 6,000 pages. And more complicated partnerships have skyrocketed from less than 5% of total income in 1990 to over a third today. As a result, the tax gap – the amount of unpaid taxes – has grown to enormous levels. It's estimated at $7 trillion over the next decade. And since the IRS has lacked the resources to effectively audit high earners – whose audits are more complex and take more time – these high earners are responsible for a disproportionate share of unpaid taxes. To illustrate: In 2019, the top one percent of Americans was estimated to owe over a fifth of unpaid taxes – totaling around $160 billion. Data shows that less than half of all taxes from more complex sources of income are paid. Yet nearly all taxes due from wages and salaries – which are earned by ordinary Americans – are paid.
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> Remarks available at **https://home.treasury.gov/news/press-releases/jy0952#_ftnref10.**

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

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

> The IRS has a goal of filling approximately 19,000 positions in FY 2023. However, representatives from the Human Capital workstream indicated that realistically the net gain of employees will be closer to 5,000 to 10,000 as these new hires will be offset by separations. A continued challenge the IRS faces is having to evaluate a high number of applicants in order to find successful candidates both willing to accept the job offer and also be able to pass the required background checks….
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> When the IRA legislation was being drafted, it included language to allow the IRS to have critical pay and direct hire authority. However, the language giving the IRS expanded hiring authority was removed from the bill. Subsequent to the passage of the IRA, the IRS requested direct hire authority to hire up to 10,000 positions annually through the end of FY 2027 for the Services and Enforcement organizations. This authority would enable the IRS to satisfy mission-critical hiring needs and support significant changes in tax law, customer outreach, and other highly complex tax compliance efforts.
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> In addition, the IRS also requested approval of direct hire authority to fill up to 4,500 positions throughout the Operations Support organizations through the end of FY 2024 ….
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> As mentioned previously, IRA legislation did not provide the IRS with critical pay authority. Critical pay authority would have allowed the IRS to increase the basic pay for certain positions in order to recruit and retain experts. IRS officials indicated that because the IRS does not know what positions could have been filled using critical pay authority, it is difficult to determine the impact of not having this authority.
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> … However, IRS officials do not believe there is an immediate risk of violating the Secretary's commitment [not to use IRS funding to increase audits of taxpayers making under $400,000 a year] **because employee attrition and hiring challenges will limit its ability to conduct more audits.**

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

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

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

The 2022 midterm election suggests that the country is very evenly divided politically. The split Congress means that a major tax legislative package is very unlikely and the likelihood of any significant transfer tax legislation (or legislative changes regarding grantor trusts) is also very unlikely for the next several years. Among other things, Democrats want a restoration of the 2021 version of the child tax credit and approval of a global minimum tax, and Republicans would like to make permanent the individual income tax provisions in the 2017 Tax Act. Tax matters that were discussed as part of the FY 2023 omnibus spending bill (ultimately passed as the Consolidated Appropriations Act, 2023) included extending the expanded child tax credit desired by Democrats and several business tax breaks (including the research and development deduction, net interest expensing, and bonus depreciation) desired by Republicans, but no agreement could be reached as to those tax issues. Reaching such an agreement in 2023 will also be difficult.

> None of that will happen in a divided Congress. Still, lawmakers may try to address several important, but smaller, tax law changes. They include new retirement savings incentives, a modest expansion of the [child tax credit], and some important business tax breaks that expired this year.
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> The question is whether either party will pursue legislation that can become law or spend time trying to advance their partisan agendas….
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> …
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> **The Inflation Reduction Act (IRA)** Democratic control of the Senate ends Republican dreams of rolling back the two major corporate tax hikes in the bill passed last summer—a minimum tax on book income and a 1 percent tax on stock buybacks.
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> **Extending the TCJA.** Even if the House passes a bill to extend the individual income tax provisions of the 2017 tax cut, which are due to expire at the end of 2025, the measure will die in the Senate.
>
> **Individual income tax cuts.** This could be a sleeper. If the economy slumps, Congress could enact some temporary tax cuts. But lawmakers of both parties will have to decide whether they want a political message or a compromise bill that becomes law.
>
> **Retirement savings.** There is broad bipartisan support in the current Congress to increase tax subsidies for retirement savings. Lawmakers could agree to a consensus measure in a lame duck session. If not, it could come up again next year.
>
> …
>
> **The best bet**: Expect nasty partisan wrangling over the debt limit and a possible government shutdown as well as deep ideological divisions among the Republicans. The result will be little or no major tax legislation in 2023. But some narrow bills could pass, as both parties start to jockey over their tax agendas for the 2024 campaign.

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

The likelihood of the $10 million (indexed) estate and gift basic exclusion amount being reduced before it is scheduled to be reduced to $5 million (indexed) in 2026 is very unlikely. Even if the Democrats win control of the administration and Congress in 2024 elections, the new Congress would not be seated until 2025, so a change in the exclusion amount before 2026 would occur mid-year in 2025 (or perhaps retroactive to January 1, 2025), both of which are extremely unlikely. Whether the $10 million exclusion amount is extended beyond 2025 will depend on whether compromises can be reached to achieve some tax legislative changes in the 2023-2024 Congress (which is unlikely, as discussed above) and, if not, will depend on whether Republicans achieve gains in the 2024 election.

e. **FY 2023 Omnibus Spending Bill – Consolidated Appropriations Act, 2023.** The Consolidated Appropriations Act, 2023, signed by the President on December 29, 2022, is an omnibus spending package that calls for $1.7 trillion in discretionary resources across the fiscal year 2023 appropriations bills, funding the federal government through September 30, 2023. In addition to allocating spending levels for federal agencies, the Act also provides $45 billion in emergency funding for Ukraine and includes retirement provisions in Division T of the Act titled the "SECURE 2.0 Act of 2022" (described in Item 4.i below). Negotiations about the omnibus spending package included discussions about some major tax provisions, with Democrats wanting the expanded child tax credit and Republicans wanting extensions of some of the business provisions in the 2017 Tax Act, but no agreement could be reached regarding those tax provisions. See Item 2.d above.

f. **Accelerating Charitable Efforts (ACE) Act Proposal.** Sen. Angus King (I-ME) and Sen Chuck Grassley (R-IA) on June 9, 2021, introduced bipartisan legislation, the Accelerating Charitable Efforts (ACE) Act, to cause philanthropic funds to be made available to working charities within a reasonable time period by tightening restrictions on donor advised funds (DAFs) and private foundations. An essentially identical proposal, H.R. 6595, was introduced in the House on February 3, 2022, by Representative Chellie Pingree (D-ME). A similar proposal will likely be introduced in 2023.

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

This proposal includes –

- Additional restrictions on DAFs with differing restrictions depending on whether the donor's advisory privilege ends within 15 years;
- Administration expenses and distributions to DAFs would not count toward the 5% minimum distribution requirement for private foundations; and
- Exemptions from the investment income excise tax would apply for foundations that (1) make. qualifying distributions in excess of 7% of the foundation's asset value (other than direct use assets) or (2) have a specified duration of not more than 25 years and do not make distributions to other private foundations having a common disqualified person.

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

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

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

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

h. **Focus by Ways & Means Committee in 2023 on Preserving Basis Step-Up and Other Measures Benefitting Rural Taxpayers.** The change of the composition of the House Ways and Means Committee to give more representation by members representing rural districts may result in a shifting focus in priorities. Chairman Jason Smith (R-Mo.) presents himself as a champion for working families, small businesses, and farmers, "not the people on K Street." As an example of the shift in focus, Chairman Smith has said that providing more exceptions to the book minimum tax is not his first priority. One of the new committee members, Rep. Randy Feenstra (R-Iowa), intends to introduce legislation shielding the stepped-up basis and like-kind exchanges. Rep. Michelle Fischbach (R-Minn.), who moved from the Agriculture Committee to Ways and Means this year, wants to bolster tax policies that bolster farmers and, and preserving the stepped-up basis is a top priority for her to protect farmers who want to pass their land to a family member. *See* Samantha Handler, *Rural Tilt on Ways and Means Puts Focus on Stepped-Up Basis*, BLOOMBERG DAILY TAX REPORT (February 2, 2023).

3. Corporate Transparency Act Overview

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

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

Following is a brief overview of highlights of the beneficial ownership reporting requirements. For a more detailed summary of the reporting requirements under the CTA see Item 3 of Estate Planning Current Developments and Hot Topics 2022 (December 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

(1) **Reporting Companies.** "Reporting Companies" that must report are corporations, LLCs, and other "similar entities" that are created by filing a document with a secretary of state or similar office or foreign entities registered to do business in the U.S. At this point, private trusts are not included among the entities that must report, and charitable organizations, including private foundations, are specifically exempt from the reporting requirements. Various other exceptions apply including companies that employ more than 20 people and that have gross receipts exceeding $5 million. **Most of the corporations, limited partnerships, and LLCs that estate planning professionals create for their clients will NOT be exempt**.

(2) **Beneficial Owners.** A "Beneficial Owner" (who must be reported) is any individual who directly or indirectly (i) exercises substantial control over a Reporting Company or (ii) owns or controls at least 25% of the Reporting Company. If a trust exercises substantial control or owns at least 25% of the Reporting Company, the regulations generally treat as Beneficial Owners (i) trustees "or other individual (if any) with the authority to dispose of trust assets" (query, would that include investment advisors or distribution advisors for directed trusts or someone who holds a power of appointment or someone who holds a veto power over distributions?), (ii) a trust beneficiary who "is the sole permissible recipient of income and principal from the trust" or who can demand distribution of or withdraw substantially all of the trust assets, and (iii) the trust grantor or settlor who has the right to revoke the trust or otherwise withdraw all of its assets. 31 C.F.R. §1010.380(d))(2)(ii)(C). The regulations do not address how this applies to corporate trustees; the CTA generally requires reporting about **individuals**, so will individuals who are primarily responsible for decisions on behalf of the corporate trustee for the trust have to be identified?

(3) **Applicants.** "Applicants" (who create a company) must also be reported. The final regulations clarify this means "the individual who directly files the document to create or register the reporting company and the individual who is primarily responsible for directing or controlling such filing if more than one individual is involved in the filing." 31 CFR §1010.380(e). Final regulations also provide that Applicants do not have to be reported for companies that are created before the effective date of the regulations (January 1, 2024), and information about Applicants will not have to be updated.

(4) **Beneficial Ownership Information Reports.** "Beneficial Ownership Information Reports" must be filed by Reporting Companies. The Reporting Company must identify itself (full legal name, any trade name or doing business name, current address, state of formation, and IRS taxpayer identification number) and report four pieces of information about beneficial owners (and, for companies created after January 1, 2024, about applicants who created the entity): (1) name, (2) birthdate, (3) address, and (4) a unique identifying number and issuing jurisdiction from an acceptable identification document (passport, state identification document, or driver's license) and an image of the document. If an individual provides the four pieces of information to FinCEN directly, the individual may obtain a "FinCEN Identifier," which can then be provided to FinCEN in a Beneficial Information Report in lieu of the required information about the individual. (Attorneys who form a substantial number of reporting entities may wish to obtain a FinCEN Identifier.) Forms for reporting this information have not yet been prepared by FinCEN.

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

(6) **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. 31 USC §5336(h)(3)(A).

(7) **Who Will Be Filing Reports?; Massive Effort as We Approach 2025.** There are some indications informally that accountants may not want to file these reports (because they have nothing to do with tax.) If that is the case, attorneys may end up filing many of these reports for entities they have created (or will create) for their clients. Reports for the hundreds (or thousands) of entities that an attorney may have created in the past will be due January 1, 2025. That is a long time out, but the filing process could be a massive effort as we approach 2025.

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

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

A helpful summary of the beneficial ownership reporting rules is summarized in the Beneficial Ownership Information Reporting Rule Fact Sheet published on the FinCEN website in connection with the release of the final regulations. The Fact Sheet is available at **https://www.fincen.gov/beneficial-ownership-information-reporting-rule-fact-sheet**.

c. **Additional Guidance.** FinCEN issued proposed regulations on December 15, 2022, governing the disclosure, access, and safeguarding of beneficial ownership information (referred to as BOI). A third set of guidance dealing with revised customer due diligence rules is anticipated by January 1, 2025.

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

Over the last decade, bar groups and ACTEC have fought against a requirement that attorneys must file "suspicious activity reports" on their clients (without notice to their clients), **but that may come at some point.** The "Establishing New Authorities for Business Laundering and Enabling Risks to Security Act," or ENABLERS Act, would expand the list of "gatekeepers" who are required under the Bank Secrecy Act to conduct due diligence on clients and file suspicious activity reports, and the expanded list would include attorneys who assist in financial-related transactions such as the formation of companies and trusts. The ENABLERS Act passed the House of Representatives on July 14, 2022, on a 329 to 101 vote (obviously with broad bipartisan support).

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

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

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

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

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

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

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

As to the timing of final regulations, William Evans (Treasury Office of Benefits Tax Counsel) said in a recent conference sponsored by the District of Columbia Bar Taxation Community that there are several drafted projects that are "close to being published" but that have been affected by provisions of SECURE 2.0. The IRS is considering whether to delay the issuance of final regulations until the provisions impacted by SECURE 2.0 can be revised.

> Evans said that one option for Treasury would be to take what it can from what has already been prepared and address the SECURE 2.0 provisions that would be relevant to the guidance — particularly provisions with a current or imminent effective date — and delay other topics.
>
> Guidance could come as "a grab-bag notice" that provides immediate, necessary guidance or as a regulatory project, Evans said, adding that the route taken would depend on the effective dates and "whether they're sort of permissive ideas or whether they're required ideas."
>
> Evans noted that Treasury is trying to understand what key things practitioners and taxpayers have questions about to determine what to include in the early package of regulations versus a later grab-bag notice.
>
> "This is still a little bit fluid, what we're going to do, but those are some of the things that we're thinking about," Evans said.

Caitlin Mullaney, *Treasury Reconsidering Retirement Guidance in Wake of SECURE 2.0*, TAX NOTES TODAY FEDERAL (Jan. 27, 2023).

For a fairly detailed summary of highlights of the proposed regulations, see Item 4.d of Estate Planning and Hot Topics 2022 (December 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** 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.**

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

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

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

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

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

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

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

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

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

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

(4) **Accumulation Trusts Generally Used.** Other than for surviving spouses (and not-more-than-10-years-younger beneficiaries), accumulation trusts will probably be used if the owner wants a trust

to receive plan distributions. Accumulation trusts for minor children or for disabled or chronically ill individuals will qualify for the modified lifetime payout exception under the proposed regulations.

e. **Natalie Choate Analysis for Testing a Trust Beneficiary.** Natalie Choate at the 57th Heckerling Institute on Estate Planning™ described a detailed 4-step analysis with 10 "disregard" rules for determining the countable beneficiaries of a trust and applying the RMD rules for the trust beneficiaries. (Natalie's written materials are a fantastic resource for analyzing the RMD rules under the SECURE Act, including for trusts as beneficiaries.) For another outstanding discussion of the treatment of trusts as beneficiaries under the proposed regulations see Natalie Choate, *How to Test a Trust Under the New Proposed Minimum Distribution Rules*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #796 (November 15, 2022).

(1) **Overview of Four-Step Analysis.** The four steps of the trusts analysis are (1) determine if the trust meets the four requirements to be a "see-through" trust, (2) make a list of all potential beneficiaries who could ever conceivably receive money under the trust, (3) divide the potential beneficiaries into two tiers of beneficiaries, and (4) apply certain "disregard" rules to the potential beneficiaries to get the countable beneficiaries.

(2) **Step One–Does the Trust Pass the Four Rules to be a See-Through Trust?** The four rules that must be satisfied for a trust to be a see-through trust are: (1) the trust is valid under local law; (2) the trust is irrevocable or becomes so at the participant's death; (3) the beneficiaries are identifiable; (4) certain documentation is provided to the plan administrator by October 31 after the year of the participant's death. Prop. Reg. §1.401(a)(9)-4(f)(2). (Natalie suggests that a trust for which beneficiaries cannot be identified is likely not a valid trust under local law.)

(3) **Step Two–List ALL Potential Beneficiaries.** Identify all beneficiaries that could conceivably receive distributions, including under the "wipe-out" clause and as appointees under a power of appointment, but with some special exceptions. The following three disregard rules apply to all trusts.

(a) **Predeceased Individual.** Exclude anyone who predeceased the plan owner.

(b) **Nonexistent Individuals.** Exclude anyone who does not exist at the plan owner's death. (Do not include future offspring who may become trust beneficiaries in the future.)

(c) **Appointees Under Power of Appointment.** Exclude appointees under a power of appointment. Only the takers in default of exercise of the power of appointment are included as potential beneficiaries. However, after a power of appointment is exercised, going forward any actual appointee is included as a potential beneficiary. (A testamentary power of appointment cannot be exercised until the powerholder has died.)

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

(d) **Disclaimer.** Disregard any beneficiary who disclaims his interest in a qualified disclaimer before the BFD. Prop. Reg. §1.401(a)(9)-4(c)(3)(i).

(e) **Distributions.** Disregard any beneficiary who is distributed all of his interest in the plan before the BFD. Prop. Reg. §1.401(a)(9)-4(c)(3)(iv).

(f) **Reformation or Decanting.** Disregard any beneficiary who is removed as a beneficiary pursuant to a reformation or decanting action prior to the BFD that is permissible under state law. The reformation exception only applies to post-death reformation of a trust, not the post-death reformation of a beneficiary designation form.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

This exception is very useful for minor children who are trust beneficiaries; such trusts need not be conduit trusts for the child to qualify for the "minor child" EDB exception. The trust could provide that the trustee could make distributions for the child's HESM and distribute all assets to the child by age 31. That trust would qualify for the EDB minor child exception (and RMDs could be made based on the child's life expectancy, with all of the assets being distributed by age 31).

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

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

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

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

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

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

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

(6) **Step Five–Determine the Distribution Period.** Once you know the countable beneficiaries, apply the following rules to determine the distribution period. The distribution period is generally (i) over some period of time (the life expectancy of some individual if there are DBs) but (ii) with an outer limit year (for example, it may be 10 years after the owner's death if there is no EDB or 10 years after an EDB ceases to be an EDB). The proposed regulations state the general rule that minimum distributions are determined by dividing the account balance by an "applicable denominator" (if there are DBs). Prop. Reg. §1.401(a)(9)-5(a)(1). Special rules are described below.

(a) **No DB.** If any of the countable beneficiaries is not an individual (e.g., an estate or a charity), the trust, or if the trust flunked Step One, the trust is not a DB. The distribution period is (i) the owner's "ghost life expectancy" at the owner's death (his life expectancy if still living) if death occurs after the owner reached his RBD and (ii) five years if the owner died before his RBD.

(b) **Conduit Trust.** For a conduit trust, the distribution period is the same as if the conduit beneficiary had been named directly as the plan beneficiary. For example, it would be 10-years if the beneficiary is not an EDB and it would be the modified life expectancy if the beneficiary is an EDB (if the beneficiary is a spouse, life expectancy can be redetermined annually, but special rules apply after 2023 under SECURE 2.0, see Item 4.i(12) below).

(c) **Type II AMBT.** A Type II "Applicable Multi-Beneficiary Trust" (AMBT) is a trust having a disabled or chronically ill ("D/CI") beneficiary (or beneficiaries) for which no distributions may be made to anyone other than the D/CI beneficiary during his lifetime. The general rule for a Type II AMBT is that the benefits are distributed over the life expectancy of the oldest D/CI beneficiary, and the outer limit year is 10 years after the death of the D/CI beneficiary (or the last D/CI beneficiary to die if there are more than one). But there are exceptions to this general rule apply. SECURE 2.0 adds that at the death of the D/CI beneficiary, the assets of a Type II AMBT can pass to charity (other than a private foundation or donor advised fund). *See* Ed Morrow & Nancy Welber, *Secure 2.0 Act Enhances Special Needs-See Through Trust Planning*, LEIMBERG ESTATE PLANNING NEWSLETTER #3028 (March 30, 2023).

(d) **Trust With Any Minor Child EDB.** If the trust has any minor child EDB as a beneficiary, a life expectancy payout can be used, but surprisingly the oldest countable beneficiary's life expectancy is used, even if he is not the minor child EDB.

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

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

(e) **All Beneficiaries are EDBs.** If all the trust beneficiaries are EDBs and none of the prior rules apply, generally use the life expectancy of the oldest EDB. But there are exceptions and special rules.

i. **Greater of Rule.** If the owner dies after his RBD and if the owner's ghost life expectancy is longer than the life expectancy of the oldest DB, the ghost life expectancy can be used, Prop. Reg. §1.401(a)(9)-2(a)(4), 5(d)(1)(ii), but the outer limit year is when the oldest EDBs life expectancy drops to one or below or, if earlier, 10 years after the death of such oldest EDB. Prop. Reg. §1.401(a)(9)-5(e)(3), (f)(1)(ii).

ii. **Other Exceptions.** Other exceptions can apply in special circumstances.

(f) **Trust That Is DB Trust But None of Above Apply.** If all countable beneficiaries are (i) individuals, (ii) none are EDBs, and (iii) none of the conduit trust rule, Type II AMBT trust, and minor child EDB rules apply, the 10-year rule will apply.

i. **Death Before RBD.** If the owner died before the RBD, **no** distributions must be made during years 1-9 but all of the plan must be distributed by December 31 of the 10th year.

ii. **Death After RBD.** If the owner died after the RBD, the proposed regulations take the position that annual distributions are required in years 1-9 based on the oldest beneficiary's life expectancy, and the entire balance must be withdrawn in year 10. Prop. Reg. §1.401(a)(9)-5(f)(1)(i). See Item 4.f below.

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

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

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

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

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

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

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

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

Thus, whether the owner dies before the RBD or on or after the RBD is critically important under the proposed regulations as to whether distributions must be made during the 10-year period following the owner's death. (For a Roth IRA, the owner is deemed to have died before the RBD, so no annual payments are required during the 10-year period even if the owner actually died on or after the RBD, Prop. Reg. §1.408-8(b)(1)(ii).)

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

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

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

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

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

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

(4) **Uncertainty for 2021 Minimum Distribution Requirements.** The changed position 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 was no need to address minimum distribution requirements for 2020 because the CARES Act waived any minimum required distributions for 2020.)

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

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

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

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

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

The Notice does not remove the distributions in 2021 and 2022 as being "required minimum distributions (RMDs)," but just says that the harsh 50% excise penalty will not be imposed for the failure to make the distributions in 2021 or 2022. This distinction may be important in some circumstances. For example, spouses wanting to do a spousal rollover or other beneficiaries wanting to roll a plan received from a decedent into an inherited IRA cannot rollover RMDs. Furthermore, for retirement plan interests payable to a trust, under §409 of the Uniform Principal and Income Act (but not the newer Uniform Fiduciary Income and Principal Act), the amount to be allocated to trust income may depend, to some extent, on "the part that is required to be made during the accounting period." Also, the beneficiary's creditors might be able to reach amounts that were required to be distributed.

Informal indications are that Treasury does not intend that "make-up" distributions will be required in 2023 for required distributions that were not made in 2021 and 2022.

g. **New Life Expectancy Tables for Retirement Plan Required Minimum Distributions.** The Single Life and Uniform Life tables for calculating required minimum distributions are in Reg. §1.401(a)(9)-9(b)-(c). The tables had not been modified for two decades, but final regulations were issued November 4, 2020 (T.D. 9930, published in the Federal Register on November 12, 2020), with an effective date of January 1, 2022. The final regulations (which include the new tables) are located at **https://www.regulations.gov/document/IRS-2019-0050-0057**. As an example, using the new tables, the life expectancy of a 72-year-old person under the single life table is 17.2 years (vs. 15.5 years under the old table) and under the uniform life table is 27.4 years (vs. 25.6 years under the old table). For a discussion of the new tables and the mechanics of applying the tables, see Item 4.g of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

h. **New Life Expectancy Tables for Pre-Age 59½ Distributions.** Notice 2022-6 updates the life expectancy tables used for calculating a series of substantially equal periodic payments ("SOSEPP"), a popular method of avoiding the 10% tax on pre-age 59½ distributions. Notice 2022-6 replaces Rev. Rul. 2002-62 for any series of payments beginning on or after January 1, 2023, and may be used for a series of payments commencing in 2022. For a discussion of planning considerations for planning SOSEPP distributions using the new tables, see Vanessa L. Kanga & Natalie B. Choate, *New Life 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. Several similar versions were considered in the Senate, and an agreed version titled "SECURE 2.0 Act of 2022" was included in Division T of the FY 2023 omnibus spending bill, the Consolidated Appropriations Act, 2023, which was signed by the President on December 29, 2022 (i.e., the date of enactment). SECURE 2.0 is an expansive (130 pages of legislative text!) addition of a wide variety of retirement savings enhancement provisions. A very helpful Committee section by section summary of SECURE 2.0 is available at **https://www.finance.senate.gov/imo/media/doc/Secure%202.0_Section%20by%20Section%20Summary%2012-19-22%20FINAL.pdf.** Some of the added provisions are briefly summarized.

(1) **Increased Age for Required Beginning Date for Mandatory Distributions.** One of the most notable changes in SECURE 2.0 is the increased age of the required beginning date for retirement plan distributions. The SECURE Act of 2019 increased the required beginning date ("RBD") age from 70 ½ to 72. SECURE 2.0 increases the RBD to age 73 for those who reach age 72 after 2022 and increases it to age 75 for those who reach age 74 after 2032.

(2) **Expanding Automatic Enrollment in Retirement Plans.** In plan years beginning after 2024 Section 401(k) and 403(b) plans will be required to automatically enroll participants upon becoming eligible (and the employees can opt out of coverage). The initial automatic enrollment amount is at least 3 percent but not more than 10 percent (and the amounts will increase in subsequent years). Existing plans, governmental plans, church retirement plans, and plans for new or small businesses are not subject to the new automatic enrollment requirement.

(3) **Saver's Match.** For lower income taxpayers (for joint returns, phasing out between $41,000 to $71,000 of income), the current nonrefundable credit for contributions to IRAs will be replaced with a 50 percent match deposited into the IRA, up to $2,000 per individual.

(4) **Catch-Up Contributions.** Under current law, individuals aged 50 and older may make catch-up contributions in excess of otherwise applicable limits. The limit is $6,500 for 2022 and $7,500 for 2023 ($3,000 in 2022 and $3,500 in 2023 for SIMPLE plans). Beginning in 2025, the limit will be increased for Individuals aged 60 to 63 to the greater of $10,000 or 150 percent of the 2024 amount. (The increased amounts are indexed for inflation after 2025.)

(5) **Roth Treatment for Matching Contributions and Catch-Up Contributions.** SECURE 2.0 permits Roth treatment to be elected for employer matching contributions (effective on the date of enactment, December 29, 2022), and for catch-up contributions (for taxable years beginning after 2023).

(6) **Rollovers From 529 Plans to Roth IRAs.** A concern with 529 plans is that leftover funds no longer needed for educational purposes may be trapped in the account unless a penalty is paid when the account is withdrawn for a non-qualified purposes. SECURE 2.0 permits a beneficiary of 529 accounts to rollover up to $35,000 over her lifetime from any 529 account into her Roth IRA. The rollovers are subject to Roth IRA annual contribution limits, and the 529 account must have been open for more than 15 years. The new provision applies to distributions after 2023.

(7) **Qualifying Longevity Annuity Contracts (QLACs).** Qualifying longevity annuity contracts (QLACs) are deferred annuities that can delay payments until the individual reaches age 85. Because payments start so late, QLACs are an inexpensive way for individuals to hedge the risk of outliving savings. Limitations imposed under regulations, however, have reduced their

usefulness. The statute addresses some of these limitations. It eliminates the requirement that premiums for QLACs be limited to 25% of the account balance, allows up to $200,000 (indexed) (up from $125,000) to be used to purchase a QLAC, relaxes the effects of divorce on a QLAC with spousal survivor rights, and allows a 90-day free look-back period by permitting rescission of the QLAC purchase within 90 days.

(8) **Reduction in Excise Tax and Statute of Limitations for Failure to Take Required Minimum Distributions.** The excise tax for failing to take required minimum distributions is reduced from 50 to 25 percent and is further reduced to 10 percent if the distribution failure is corrected in a timely manner. The new provision applies to taxable years beginning after the date of enactment (December 29, 2022). Effective on the date of enactment, the statute of limitations for excise taxes on the failure to make required minimum distributions will generally be three years from when the owner files an individual tax return (Form 1040) for the year of the violation (under prior law the limitations period ran from when a Form 5329 was filed for the violation).

(9) **IRA Charitable Rollovers.** The $100,000 limit for IRA charitable distributions for owners over age 70 ½ will be indexed for inflation (rounded to the nearest thousand) beginning in 2024. Also, a one-time distribution up to $50,000 is allowed from an IRA (again, for owners over age 70 ½) to a charitable remainder trust or charitable gift annuity meeting certain requirements. (Such charitable gift annuity must commence fixed payments of 5% or more not later than one year from the date of funding; the 5% distribution requirement can be a problem for single life annuities if the annuitant is under age 61 and for joint annuities for a married couple if the younger spouse is younger than about age 64). The $50,000 amount will be indexed for inflation after 2023. *See generally* Ed Morrow, *New Qualified Charitable Distribution (QCD) Provisions in SECURE Act 2.0 – Some Welcome, Some Dubious*, LEIMBERG CHARITABLE PLANNING NEWSLETTER #325 (February 6, 2023).

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

(10) **Treatment of IRA Involved in a Prohibited Transaction.** If a person has multiple IRAs and engages in a prohibited transaction, only the IRA with respect to which the prohibited transaction occurred will be disqualified.

(11) **Roth Plan Distribution Rules.** Required minimum distribution rules do not apply to Roth IRAs prior to the death of an IRA owner, but under prior law, pre-death distributions were required for Roth accounts of 401(k) plans. Under SECURE 2.0 the pre-death distribution requirement for 401(k) Roth accounts is eliminated, effective for taxable years beginning after 2023.

(12) **Surviving Spouse Election; Use of Uniform Life Table for Conduit Trusts.** For calendar years beginning after 2023, surviving spouses may elect to be treated as the employee (i.e., as the plan participant) for purposes of the required minimum distribution rules. In addition, if the spouse makes that election, the spouse (or, importantly, a conduit trust for the spouse), may use the uniform life table (rather than the single life table) for determining the amount of distributions over the spouse’s life expectancy.

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

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

- Under current law, the surviving spouse does not have to make an affirmative election to delay taking distributions until the deceased owner would have reached his or her RBD. Beginning in 2024, an affirmative election will be required by the spouse to make use of the delayed distribution option.
- Under current law, a surviving spouse beneficiary receiving plan benefits outright could roll the benefits into his or her own IRA and could then use the uniform life table to determine the RMD each year. Beginning in 2024, a surviving spouse can use the uniform life table (and recalculate life expectancy annually) without rolling the proceeds into a spousal IRA but only if the spouse makes the election.
- Importantly, a conduit trust is treated as if the surviving spouse were the beneficiary, so a conduit trust can also use the uniform life table (and recalculate life expectancy annually) beginning in 2024 if the election is made. Under current law (and beginning in 2024 if the election is not made) a conduit trust for a surviving spouse had to use the single life table (but could recalculate life expectancy annually).

For an excellent discussion of these complicated new rules (beginning in 2024) see Ed Morrow, *Secure 2.0 Offers Longer Stretch for Conduit Trusts, but Contains Traps for Surviving Spouses*, LEIMBERG EST. PL. NEWSLETTER #3010 (Jan. 24, 2023).

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

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

(15) **Conservation Easements.** SECURE 2.0 is a legislative follow-up to Notice 2017-10 treating certain syndicated conservation easements as "listed transactions," after the validity of Notice 2017-10 has come into question (see Item 21.c(3) below). The legislative provisions are described in Item 21.c(6) below.

Error Regarding Catch-Up Contributions. The provision allowing Roth treatment for catch-up contributions inadvertently omitted a subparagraph that has the effect of banning all catch-up contributions beginning in 2024. The mistake may be corrected legislatively, but if that is not done before 2024, the IRS may attempt a fix through regulatory action with the expectation of a future legislative correction. *See* Caitlin Mullaney, *Response to SECURE 2.0 Catch-Up Contribution Error in Limbo*, TAX NOTES TODAY FEDERAL (Feb. 16, 2023).

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

a. **2022-2023 and 2021-2022 Treasury-IRS Priority Guidance Plans.** The 2022-2023 Treasury-IRS Priority Guidance Plan (released November 4, 2022) adds three new projects in the "Gifts and Estates and Trusts" section:

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

(2) Regulations under §20.2056A-2 for qualified domestic trust elections on estate tax returns, updating obsolete references (Number 7); and

(3) Guidance on portability regulatory elections under §2010(c)(5)(A) (Number 4) [already published as Rev. Proc. 2022-32] (discussed in 5.e below).

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

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

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

The following are items regarding gifts and estates and trusts in the 2022-2023 Plan.

GIFTS AND ESTATES AND TRUSTS

1. 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.

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

3. Regulations under §2010 addressing whether gifts that are includible in the gross estate should be excepted from the special rule of § 20.2010-1(c). Proposed regulations were published on April 27, 2022.

4. Guidance on portability regulatory elections under §2010(c)(5)(A).

- PUBLISHED 07/25/22 in IRB 2022-30 as REV. PROC. 2022-32 (RELEASED on 07/08/22).

5. 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.

6. Final regulations under §2053 regarding the deductibility of certain interest expenses and amounts paid under a personal guarantee, certain substantiation requirements, and the applicability of present value concepts in determining the amount deductible. Proposed regulations were published on June 28, 2022.

7. Regulations under §20.2056A-2 for qualified domestic trust elections on estate tax returns, updating obsolete references.

8. 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.

9. Final regulations under §2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption. Proposed regulations were published on April 17, 2008.

10. 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.

11. Regulations under §7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests. Proposed regulations were published on May 5, 2022.

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

The 2022-2023 Plan sets the priority for guidance projects during the Plan year (from July 1, 2022, to June 30, 2023), but no deadline is provided for completing the projects.

Proposed regulations have been issued within the last year with respect to three of the items on the Plan (Numbers 3 [abuse exception to the anti-clawback regulation], 6 [§2053], and 11 [actuarial tables]). Melissa Liquerman (IRS Office of Chief Counsel) in a recent presentation at a District of Columbia Bar tax conference said, "We're really putting a lot of time and effort into finalizing these regulations as soon as possible." Naomi Jagoda, *IRS Working to Issue Final Rules on Estate-Tax Projects*, BLOOMBERG DAILY TAX REPORT (January 25, 2023).

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

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 said she thought that proposed regulations would be coming out "fairly soon" regarding the deductibility of personal guarantees and the application of present value concepts under §2053 (and those proposed regulations were released June 24, 2022). 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).

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

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

This much narrower topic, about grantor trusts for which the assets are not included in the grantor's gross estate was included for the first time as Number 2 of the Gifts Estates and Trusts issues on the 2022-2023 Plan. It apparently is the IRS's response to a statement by Secretary of the Treasury Janet Yellen's in a dialogue at a June 8, 2022, House Ways and Means Committee hearing that the IRS would be implementing guidance on the "infamous stepped-up basis loophole" "Very soon. Very soon."

Beginning in 2015, the IRS no-ruling list includes whether "the assets in a grantor trust receive a Section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner …" *E.g.*, Rev. Proc. 2022-3, 5.01(11).

(1) **Statutory Provisions.** Section 1014(a) provides generally that the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent is adjusted to the fair market value at the date of death. Section 1014(b) describes six categories of assets that "shall be considered to have been acquired from or passed from the decedent (A seventh category applies for decedents dying before 2005.)

(2) **Arguments.** Some planners maintain that assets in a grantor trust should receive a basis step-up at the grantor's death because until that time the assets were deemed owned by the grantor for income tax purposes (*See* Rev. Rul. 85-13, 1985-1 C.B. 184), and after the grantor's death they are "acquired from a decedent" by someone else. *See e.g.*, Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (Sept. 2002); Treas. Reg. §1.1001-2(c)EX. 5 (grantor of grantor trust was considered

the owner of all trust property in a grantor trust and when grantor renounced powers that caused trust to be a grantor trust, partnership interest owned by the trust was considered to have been transferred from grantor to trust for Federal income tax purposes). Many other planners are uncomfortable with that position. See Austin Bramwell & Stephanie Vera, *Basis of Grantor Trust Assets at Death: What Treasury Should Do,* 160 TAX NOTES FEDERAL 793 (Aug. 6, 2018), (suggesting that §1015(b) could provide a rationale for not adjusting basis of grantor trust assets at the grantor's death).

(3) **Political Pressure.** This item in the 2022-2023 Plan is apparently the IRS's response to a statement by Secretary of the Treasury Janet Yellen's in a dialogue with Representative Bill Pascrell (D-New Jersey) at a June 8, 2022, House Ways and Means Committee hearing that the IRS would be implementing guidance on the "infamous stepped-up basis loophole" "Very soon. Very soon."

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

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

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

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

The complete holding of the Ruling is:

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

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

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

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

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

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

(7) **Penalties.** If a taxpayer wants to take the position that the IRS's position in Rev. Rul. 2023-2 is wrong, the recipient of the grantor trust asset might want to report capital gain upon the sale of the asset as if no basis adjustment applied, and then claim a refund, taking the position that a basis adjustment did apply at the death of the grantor of the grantor trust. That approach would avoid underpayment penalties if the taxpayer's position is not upheld.

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

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

d. **Anti-Abuse Exceptions to Anti-Clawback (Number 3).** Number 3 addresses the anti-abuse exception to the clawback regulation. The IRS released proposed regulations on April 26, 2022, discussed in Item 6 below.

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

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

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

f. **Alternate Valuation Period (Number 5).** This project has been on the Plan for a number of years. For further discussion of this project see Item 6.d of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

g. **Section 2053 Proposed Regulations (Number 6).** Proposed regulations were released on June 24, 2022, and published in the Federal Register on June 28, 2022. These regulations eventually could have a profound impact on planning and the deductibility of certain administrative expenses for estate tax purposes. The proposed regulation and planning implications are discussed in Item 7 below.

h. **Qualified Domestic Trust Elections (Number 7).** The QDOT project apparently is merely "updating obsolete references."

i. **GST Exemption Allocation (Numbers 8-9).** Number 8 first appeared in the 2021-2022 Plan, but it is related to Number 9, which has been in Plans for a number of years, first appearing in the 2007-2008 Plan. For a discussion of these projects, see Item 5.h of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (February 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

j. **Tax Under §2801 on Gifts from Expatriates (Number 10).** This item first appeared in the 2008-2009 Plan, and proposed regulations were issued in 2015. The item was dropped from the 2017-2018 Plan and has not been in the Plan since then. For a discussion of this issue, see Item 29.i of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (February 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

k. **New Actuarial Tables Under §7520 (Number 11).** The actuarial tables project, added in the 2019-2020 Plan, is to update the §7520 actuarial tables based on updated mortality information, which must be done every ten years and was last done effective May 1, 2009. Proposed regulations were published on May 5, 2022 (more than three years after the statutorily required date of May 1, 2019). The proposed regulations and planning issues are discussed in Item 8 below.

l. **Other Notable Omissions in 2021-2022 Plan.** Among new items added to the Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015, were the following.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

n. **Future Bold Projects Suggested by Tax Law Center at NYU Law (or "What Far Reaching Projects Might We See in the Future?").** In response to Treasury's annual request for recommendations for future projects (in Notice 2021-2), the Tax Law Center at NYU Law (the "Center") submitted a broad range of far-reaching projects on June 2, 2022. Recommendations regarding gifts, estates, and trusts are discussed in Item 5.a(6) of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

o. **Inflation Adjustments.** Inflation adjustments based on the C-CPI-U numbers published by the Bureau of Labor Statistics (typically in mid-September of each year) for 2021, 2022, and 2023 were announced in Rev. Proc. 2020-45, Rev. Proc. 2021-45, and Rev. Proc. 2022-38 respectively. Some of the adjusted amounts are as follows:

- Basic exclusion amount and GST exemption-$12,920,000 in 2023, $12,060,000 in 2022, $11,700,000 in 2021 (observe, the $860,000 increase for 2023 is much larger than prior year inflation adjustment increases and leaves substantial additional gift exclusion for additional gifts by those donors who have previously utilized all of their gift exclusion);
- Gift tax annual exclusion-$17,000 in 2023, $16,000 in 2022, $15,000 in 2018-2021 (observe that the annual exclusion was $15,000 for four years [2018-2021] before increasing to $16,000 in 2022, and now it will increase after only one year to $17,000 in 2023, and it very likely will increase to $18,000 in 2024);
- Estates and trusts taxable income for top (37%) income tax bracket-$14,450 in 2023, $13,450 in 2022, $13,050 in 2021;

- Top income tax bracket for individuals-$693,750/$578,125 (married filing jointly/single) in 2023, $647,850/$539,900 in 2022, $628,300/$523,600 in 2021;
- Taxable income threshold for §199A qualified business income-$364,200/$182,100 (married filing jointly/single) in 2023, $340,100/$170,050 in 2022, $329,800/$164,900 in 2021;
- Standard deduction-$27,700/$13,850 (married filing jointly/single) in 2023, $25,900/$12,950 in 2022, $25,100/$12,550 in 2021;
- Non-citizen spouse annual gift tax exclusion-$175,000 in 2023, $164,000 in 2022, $159,000 in 2021;
- Section 6166 "two percent amount"-$1,750,000 in 2023, $1,640,000 in 2022, $1,590,000 in 2021; and
- Special use valuation reduction limitation-$1,310,000 in 2023, $1,230,000 in 2022, $1,190,000 in 2021.

p. **Re-Emergence of Section 2704 Proposed Regulations Addressing Valuation?** Neither the FY 2022 Greenbook nor the FY 2023 Greenbook includes a regulatory project to restrict valuation discounts under §2704. Apparently, there is no intent by the Biden administration, at this point, to re-open the §2704 regulation project, but the March 20, 2023 letter to Treasury from four prominent Senators request that the proposed regulations be reissued, as summarized in Item 5.m above. (The highly controversial proposed regulations published August 4, 2016, were withdrawn on October 20, 2017, during the Trump administration. For a detailed discussion of the history of the §2704 proposed regulations, see Item 18 of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (February 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**)

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

a. **Background.** The IRS published proposed regulations in the Federal Register on April 27, 2022. REG-118913-21. The preamble to the anti-clawback final regulations, published on November 26, 2019, stated that further consideration would be given to the issue of whether gifts that are not "true inter vivos transfers," but rather are includible in the gross estate would be excepted from the anti-clawback relief provisions. Two and a half years later, these proposed regulations answer that question affirmatively. This project is Number 3 on the 2022-2023 Priority Guidance Plan mentioned in Item 5.d above.

b. **Rationale.** The preamble to the proposed regulations (referred to hereafter in this discussion as the "Preamble") reasons that the Code and existing regulations distinguish between (i) gifts that are not included in the gross estate (and are "adjusted taxable gifts") and (ii) "completed gifts that are treated as testamentary transfers for estate tax purposes and are included in the donor's gross estate (includible gift)." Preamble, citing: §2001(b) (flush language) (excluding includible gifts as "adjusted taxable gifts" for purposes of the estate tax calculation); Reg. §25.2701-5 & §25.2702-6 (excluding from adjusted taxable gifts transfers includible in the gross estate that were subject to the special valuation rules of §2701 and §2702, respectively); Rev. Rul. 84-25 (excluding from adjusted taxable gifts completed transfers, such as an enforceable gift of a promissory note, that will be satisfied with assets includible in the gross estate). Similarly, the proposed regulations deny the benefit of the anti-clawback provision to includible gifts, reasoning that including the date of death value of the transfer in the gross estate, but not also including the gift as an adjusted taxable gift in the estate tax calculation, results in subjecting those transfers "to estate tax with the benefit of only the BEA [basic exclusion amount] available at the date of death." Preamble. The general rationale of the "string" statutes (§2036, 2038, 2037, and 2042) is to treat certain transfers in which the donor retains "too much" interest or control as if the transferred assets are still subject to the estate tax, and the anti-abuse rule achieves that purpose.

c. **General Anti-Clawback Rule.** If a client made a $12 million gift in 2022 (when the gift exclusion amount was $12.06 million) but dies in 2026 after the basic exclusion amount has sunsetted to $5 million indexed (say $6.8 million), the $12 million is added into the estate tax calculation as an adjusted 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.**

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

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

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

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

The following example is based on an example in Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes*, 48-49 (February 2023) 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 proposed anti-abuse exception, though, the estate tax would be calculated using a BEA of $6.8 million, and the estate tax would be 40% x ($29 million - $6.8 million), or **$8,880,000.** Effectively, the donor would not get the benefit of having made use of the extra $9 million less $6.8 million, or $2.2 million of "bonus" exclusion amount. That $2.2 million times 40% is $880,000.

Another example of a §2036 transfer that could be caught by this proposed anti-abuse rule is the creation of a qualified personal residence trust (QPRT) if the donor should die during the term of the retained interest in the residence. *See* Brad Dillon, *QPRTs Should Come with a New Warning Label*, LEIMBERG ESTATE PLANNING NEWSLETTER #2990 (NOVEMBER 3, 2022).

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

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

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

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

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

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

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

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

i. **Example of Use of DSUE Amount.** The proposed regulation includes a detailed example of a gift by a donor who has DSUE from a predeceased spouse. The example walks through the mathematical details for determining the amount of the **donor's** BEA that was applied against gifts. The example confirms the position in the anti-clawback final regulation that the DSUE must be applied to the gift before the donor's BEA. Prop. Reg. §20.2010-1(c)(3)(iii)(C) Ex. 3.

j. **Deathbed Planning.** The proposed regulations address deathbed planning alternatives to avoid the exception by removal of the donor's beneficial use or control of the transferred property before death 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 TODAY FEDERAL (April 27, 2022).

The 18-month rule has been criticized in comments to the IRS. The American College of Trust and Estate Counsel, The Tax Law Center at NYU Law, and New York State Bar Tax Section all recommend applying a three-year test rather than an 18-month test, consistent with the approach of §2035. The Florida Bar, on the other hand, recommends that the 18-month test be reduced to a 12-month test, consistent with §1014(e). *See* Jonathan Curry, *Tax Orgs Split on Deathbed Planning in*

Anti-Clawback Regs, TAX NOTES TODAY FEDERAL (July 28, 2022). Comments have also sought clarification about whether the 18-month rule would apply to a bona fide sale of an interest.

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

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

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

m. **Comments by New York State Bar Association Tax Section.** Comments filed by the New York State Bar Association Tax Section with the IRS on July 12, 2022, make a number of recommendations regarding the proposed regulations. In a summary of their comments, the Tax Section writes that it recommends the following.

> 1. Treasury and the Service consider whether the portability regulations should be revised so that targeted gifts may not be used to lock in deceased spousal unused exclusion ("DSUE") before an individual remarries and survives a second spouse.
>
> 2. The final regulations clarify whether a targeted gift can absorb the standard BEA, even if it cannot preserve bonus BEA.
>
> 3. The final regulations clarify that some transfers are treated as targeted gifts, even if they are neither includible in the gross estate nor treated as includible.
>
> 4. Treasury and the Service consider whether gifts that the donor later borrows back should, in some cases, be treated as targeted gifts.
>
> 5. The final regulations clarify that the retention of a qualified payment right within the meaning of Section 2701(c)(3) does not cause a transfer to be treated as a targeted gift.
>
> 6. The final regulations replace or supplement the 5% rule set forth in Prop. Reg. § 20.2010-1(c)(ii)(A) with a provision that that would permit application of the anti-clawback rule in cases where the donor retains no more than a qualified retained interest within the meaning of Section 2702(b).
>
> 7. The final regulations eliminate the disparities that would arise under the Proposed Regulations in the treatment of transfers, relinquishments, or eliminations of interests, powers or property prior to death, and instead adopt a uniform and consistent rule.

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

7. Section 2053 Proposed Regulations

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

a. **Overview of Topics Addressed.** The proposed regulations address four general topics about deductions for claims and administration expenses under §2053: (1) applying present value concepts, (2) deductibility of interest, (3) deductibility of amounts paid under a decedent's personal guarantee, and (4) curing technical problems of references in existing regulations to a "qualified appraisal" for valuing claims by instead describing requirements for a "written appraisal document."

b. **Applying Present Value Concepts to §2053 Deductions.** The general rationale of allowing deductions for claims and expenses is that such amounts "do not pass to the decedent's legatees, beneficiaries, or heirs and, therefore, are not subject to the estate tax." Proposed Regulations Preamble [REG-130975-08] ("Preamble"). Although assets in the gross estate are valued under a "snapshot" method at the date or death (or the alternate valuation date, if applicable), the Preamble reasons that limiting the deduction under §2053 for claims and expenses

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

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

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

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

The Preamble explains that the rationale of requiring discounting of claims and expenses paid only after the three-year grace period is that most ordinary administration expenses are paid within three years of the date of death, three years takes into account a reasonable time for administering and closing the estate, and three years is a short enough period of time that the deduction of the full undiscounted amount of payments made within that grace period will not significantly distort the value of the net (distributable) estate. The Preamble concludes this rationale by stating that the three-year cutoff "strikes an appropriate balance between benefits and burdens."

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

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

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

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

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

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

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

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

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

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

The net effect is that "*Graegin* loans" (see *Estate of Graegin* v. Commissioner, T.C. Memo, 1988-477) will be significantly restricted under the proposed regulations. Even if a deduction is allowed for post-death interest accruing on the loan, the deduction for interest paid after three years following date of death (which may be all of the interest) will be discounted as discussed above. Proposed Reg. §20.2053-1(d)(6). Furthermore, an interest deduction may be denied totally for some loans after applying the 11 factors listed in the proposed regulations. Those factors generally reflect issues that have been addressed in various cases involving loans obtained to pay estate taxes, but some cases have not been as restrictive as is suggested by the listed factors. For example, one of the negative factors listed in the proposed regulations is whether the lender is a beneficiary or entity in which the beneficiary has control, but various cases have permitted a deduction for interest paid to a beneficiary or family entity. *E.g.*, *Beat v. U.S.*, 107 AFTR 2d 2011-1804 (D. Kan. 2011); *Estate of Murphy v. U.S.*, 104 AFTR 2d 2009-7703 (W.D. Ark. 2009); *Keller v. U.S.*, 697 F.3d 238, 110 AFTR 2d 2012-6061 (5th Cir. 2012) ($114 million borrowed after death from FLP on a 9-year note; deduction allowed; "we refuse to collapse the Estate and FLP to functionally the same entity simply because they share substantial (though not complete) common control"), *aff'g* 104 AFTR 2d 2009-6015 (2009) and 106 AFTR2d 2010-6309 (2010). Also, some courts have refused to second guess the business judgments of executors by not requiring "that an estate totally deplete its liquid assets before an interest expense can be considered necessary," *Estate of Thompson v. Commissioner*, T.C. Memo 1998-325, or requiring an estate to qualify to defer estate taxes under §6166 rather than borrowing funds to pay the estate taxes, *McKee v. Commissioner*, T.C. Memo. 1996-362.

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

In *Estate of Black v. Commissioner*, 133 T.C. 340 (2009), an FLP sold about one-third of its very large block of stock in a public company in a secondary offering, generating about $98 million to the FLP, and the FLP loaned $71 million to the estate to pay various taxes, expenses, and a charitable bequest. The estate argued four reasons for allowing an interest deduction. (1) The executor exercised reasonable business judgment when he borrowed funds, (2) the FLP was not required to make a distribution or redeem a partnership interest from the estate, (3) the son was the managing partner and executor and owed fiduciary duties to both the estate and the partnership, and (4) the loan itself was a bona fide loan. The IRS argued that the loan was (1) unnecessary and (2) not bona fide (because the transaction had no economic effect other than to generate an estate tax deduction). The court found that the loan was not necessary, basing its analysis primarily on the "no economic effect" rationale that the IRS gave in its "no bona fide loan" argument. The court noted that the partnership agreement allowed modifications, and a modification permitting a distribution of stock to the partners or a partial redemption of the estate's interest would not have violated the son's fiduciary duties, as managing partner, to any of the partners. The court reasoned further that the estate had no way to repay the loan other than actually receiving a distribution from or having its partnership interest redeemed by the partnership in return for the stock, which it would then use to discharge the debt. Instead, the partnerships sold the stock and loaned the sale proceeds to the estate. Under the court's analysis, the key factor in denying any deduction for loans obtained to pay debts and expenses seems to be that the loan was not necessary to avoid selling assets. The other cases cited by the taxpayer in which an interest deduction was allowed involved situations where the estate avoided a forced sale of illiquid assets or company stock. In this case, the company stock that was owned by the FLP was in fact sold by the FLP. *See generally* Liss, Estate of Black*: When Is It 'Necessary' to Pay Estate Taxes With Borrowed Funds?,* 112 J. TAX'N (June 2010).

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

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

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

d. **Deductibility of Amounts Paid Pursuant to Decedent's Personal Guarantee.** The proposed regulations treat a claim against the estate based on the decedent's personal guaranty as a "claim founded upon a promise" that is governed by Reg. §20.2053-4(d)(5), which requires

> that the promise or agreement was **bona fide** and **in exchange for adequate and full consideration in money or money's worth;** that is, the promise or agreement must have been bargained for at arm's length and the price must have been an adequate and full equivalent reducible to a money value. (Emphasis added.)

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

(1) **Bona Fide Requirement.** The bona fide requirement is that the agreement must have been bargained at arm's length and, in the case of a claim involving a family member, the decedent's agreement to guarantee the debt of a family member, a related entity, or a beneficiary must meet the requirements of Reg. §20.2053-1(b)(2)(ii). (This simply reiterates the "bona fide" requirement that applies to all deductions for claims under §2053.)

(2) **In Exchange for Full Consideration.** A safe harbor is provided for a decedent's guarantee of a debt of an entity in which the decedent had an interest when the guarantee was given. The guarantee will be treated as satisfying the requirement that the agreement be in exchange for adequate and full consideration if **either** of two tests are met:

- At the time the guarantee was given, the decedent had control (within the meaning of §2701(b)(2)) of the entity; or
- To the extent the maximum liability of the decedent under the guarantee did not exceed, at the time the guarantee was given, the fair market value of the decedent's interest in the entity.

(3) **Right of Reimbursement.** The amount of the deduction of payment of a guarantee is reduced to the extent of the estate's right of contribution or reimbursement.

(4) **Avoiding Double Counting.** Payments made pursuant to a decedent's guarantee of a debt are deductible as a claim only to the extent the guarantee has not been taken into account in valuing an asset of the gross estate under Reg. §20.2053-7 (by reducing the value of the asset by all or some of the amount of an unpaid mortgage or debt against the property) or otherwise.

e. **Substantiation Requirements for Valuations of Certain Administration Expense Deductions.** The regulations permit a deduction for claims against the estate under §2053 before the claim is actually paid in three circumstances: (1) claims for certain ascertainable amounts (Reg. §20.2053-1(d)(4)); (2) claims and counterclaims in a related matter (Reg. §20.2053-4(b); and (3) claims totaling not more than $500,000 (Reg. §20.2053-4(c). The new substantiation rules in the proposed regulations apply to situations (2) and (3). The existing regulations require a "qualified appraisal"(within the meaning of §170) to value such claims. The IRS has determined that certain elements of a qualified appraisal under §170 do not apply in the context of valuing a claim against the estate. The proposed regulations provide revised rules for a "written appraisal document" that must support the value of claims for purposes of Reg. §20.2053-4(b) and (c). Prop. Reg. §20.2053-4(b)(1)(iv) & Prop. Reg. §20.2053-4(c)(1)(iv).

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

f. **ACTEC Comments.** ACTEC filed comments with the IRS on September 22, 2022. The comments address (i) the illiquidity and "beneficiary as lender" issues as factors about whether interest is deductible, (ii) the penalties of perjury requirement for appraisals of claims, and (iii) the impact of receiving full consideration for personal guarantees. The ACTEC comments are available at **https://www.actec.org/assets/1/6/22.09.22_ACTEC_LTRComments_Section_2053.pdf?hssc=1**.

g. **Effective Date.** The regulations are proposed to apply to estates of decedents dying on or after the adoption of the rules as final regulations (i.e., the date of their publication in the Federal Register).

8. New Actuarial Tables

a. **Background.** The actuarial tables project, added in the 2019-2020 Plan, is to update the §7520 actuarial tables (Number 11 on the 2022-2023 Priority Guidance Plan mentioned in Item 5.a above). By statute, the tables must be revised with updated mortality information by May 1 of the ninth year of every decade. The tables were last updated May 1, 2009. The tables were not updated by May 1, 2019, as was required by §7520, but proposed regulations (REG-122770-18) were released on May 4, 2022, and published in the Federal Register on May 5, 2022, implementing new updated actuarial tables based on new Table 2010CM. (The tables effective beginning in 2009 were based on data from the 2000 census reflected in Table 2000CM.) ACTEC submitted comments on July 5, 2022, regarding the proposed regulations, available at **https://www.actec.org/resources/government-relations/**.

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

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

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

The rather dramatic increase in life expectancy from the 2010 census data compared with the 2000 census data interestingly is contrasted with a CDC report showing a decline in life expectancy over the last several years (no doubt impacted by the COVID-19 pandemic). For 2020, life expectancy at birth for the U.S. population declined by 1.5 years compared to 2019 (and declined 2.9 years for the non-Hispanic black population and 3.0 years for Hispanic individuals). National Center for Health Statistics Vital Statistics Rapid Release, Rept. No. 15 (July 2021). In 2021, life expectancy declined even further, by another 0.9 years at birth for the total population. For the period from 2019 through 2021, the life expectancy at birth declined by 2.7 years for the total population (3.1 years for males and 2.3 years for females). National Center for Health Statistics Vital Statistics Rapid Release, Rept. No. 23 (August 2022). The decreasing life expectancy of Americans is attributable to various factors in addition to the pandemic, a primary factor being the increased mortality rates of children and teenagers.

> But increasingly the American mortality anomaly, which is still growing, is explained not by the middle-aged or elderly but by the deaths of children and teenagers. One in 25 American 5-year-olds now won't live to see 40, a death rate about four times as high as in other wealthy nations. And although the spike in death rates among the young has been dramatic since the beginning of the pandemic, little of the impact is from Covid-19. Over three pandemic years, Covid-19 was responsible for just 2 percent of American pediatric and juvenile deaths.
>
> …
>
> … For the poorer half of the country, simply being an American is equivalent to about four full years of life lost compared with the average Brit. For the richer half, being an American is not quite as bad but is still the equivalent of losing, on average, about two years of life.
>
> …
>
> … If you make it to retirement age, you can expect to live about as long as your counterparts in other wealthy countries…. The country's exceptionalism of violence is more striking among the young but extends into early adulthood; from age 25 to 34, Americans' chances of dying are, by some **estimates**, more than twice as high, on average, as their counterparts' in Britain and Japan.

…

> The pandemic years look even grimmer when we examine pediatric mortality by cause. Guns were responsible for almost half of the increase from 2019 to 2020, as homicides among children age 10 to 19 grew more than 39 percent. Deaths from drug overdoses for that age cohort more than doubled. In 2021, as schools reopened, pediatric deaths from Covid nearly doubled but still accounted for only one-fifth of the increase in overall pediatric deaths — a large increase on top of the previous year's even larger one.
>
> The disparities are remarkable and striking, as well. Most of the increase in pediatric mortality was among males, with female deaths making only a small jump. Almost two-thirds of the victims of homicide were non-Hispanic Black youths 10 to 19, who had a homicide rate six times as high as that of Hispanic children and teenagers, and more than 20 times as high as that of white children and teenagers.

David Wallace-Wells, It's Not 'Deaths of Despair.' It's Deaths of Children, New York Times (April 6, 2023)

c. **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 170, 642, 664, 2031, 2032, 2036, 2055, 2056 (QDOTs), 2512, 2522, 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 earlier in August 2020.

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

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

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

The updated actuarial tables are available, at no charge, via the IRS website at **https://www.irs.gov/retirement-plans/actuarial-tables.** IRS Publications 1457 "Actuarial Valuations Version 4A", 1458 "Actuarial Valuations Version 4B", and 1459 "Actuarial Valuations Version 4C" 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.

(1) **Effective Date.** 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. Thus, there is no clarity as to when the final regulations will be issued or will be effective.

(2) **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).

Comments filed by ACTEC with the Internal Revenue Service regarding the proposed regulations state that the regulations should be revised to permit the taxpayer to elect to use the new tables for any transaction occurring on or after May 1, 2019.

> The mortality assumptions were last updated effective May 1, 2009, so new mortality assumptions should have been available for use by taxpayers for transactions occurring on or after May 1, 2019. We understand that the delay was caused by unavailability until August, 2020 of the decennial life table data compiled by the National Center for Health Statistics of the Centers for Disease Control on which prior tables issued under Code section 7520 were based. However, nothing in Code section 7520 requires use of any particular mortality data source, only that the tables "take into account the most recent mortality experience available as of the time of the revision." The proposed tables are based on mortality data which was already 9 years old in 2019. Given the mandate of Code section 7520 it seems appropriate, and perhaps legally required under Code section 7520, that the proposed new tables be available, at the election of the taxpayer, for any transaction occurring on or after May 1, 2019.

Allowing transition relief only back to January 1, 2021, rather than May 1, 2019 (as arguably required by §7520, which mandates the adoption of new tables no less frequently than once every 10 years), creates considerable confusion for certain formula-based amounts. For example, charitable lead annuity trusts (CLATs) sometime define the annuity payment as a percentage of the value of the property transferred to the CLAT that would "zero out" the remainder value of the CLAT. Would the trustee determine the percentage by applying valuation factors required by the *statute* even though the proposed regulation does not implement that statutory requirement for transfers that were made between May 1, 2019, and January 1, 2021? For a further discussion of concern with formula issues raised by the transition date, see Item 5.j.(4)(d) of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (February 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

9. Estate Planning for Moderately Wealthy Clients

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

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

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

b. **Important Planning Issues.**

- Do not ignore the GST tax. Without proper allocation (either automatically or manually) of the GST exemption (also $10 million indexed), trusts created by clients generally will be subject to the GST tax (currently 40%) at the death of the first-generation beneficiary (children of the settlor) unless the trust assets are included in the beneficiary's gross estate. Consider allocating the increased GST exemption to previously created non-exempt trusts.
- Review formula clauses that are based on the available exclusion amount to confirm they still reflect the intended result.
- Many moderately wealthy clients will want to rely on portability and leave assets at the first spouse's death either outright to the surviving spouse (and rely on disclaimers if a trust is desirable) or to a QTIP trust with a Clayton provision (which allows the most flexibility). However, a credit shelter trust approach may be appropriate for some moderately wealthy clients.
- Basis adjustment planning will be appropriate for many clients. They and their family members may not have estate tax concerns given the higher exclusion amounts even if trust assets are included in their estates, and basis adjustment planning may be appropriate for assets may qualify for a stepped-up basis at the person's death under §1014 (assuming §1014 is not repealed). See Item 7 of Estate Planning: Current Developments and Hot Topics (December 2014) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.
- Including provisions to provide flexibility to accommodate changing circumstances or changing tax laws can be very helpful.
- For planning in states with state estate taxes (about a fourth of the states), using multiple QTIP trusts may be helpful if the state recognizes QTIP trusts that are effective for state purposes only. In addition, the exclusion amount at the state level may not be portable, necessitating additional planning in states with state estate taxes.

c. **Further Discussion.** For further discussion of these issues, see Item 4 of Estate Planning: Current Developments and Hot Topics (December 2014) found **here** and Item 7 of Estate Planning Current Development and Hot Topics (May 2021) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

10. Trust Planning—Selecting Trust Jurisdiction and Governing Law

a. **Focus on Client's Objectives.** The selection of the trust's jurisdiction and governing law can assist or frustrate meeting the client's objectives. A trust is about protecting someone from someone else. Who are you protecting and who (or what) are you protecting from (such as taxes, the beneficiaries themselves, other beneficiaries, creditors, or people the grantor does not like)? The purpose(s) can be documented in the trust agreement or in a separate "Letter of Wishes." Start with the client's own words and tweak as needed for clarity.

b. **Merely Stating Governing Law in Trust Agreement Is Not Sufficient.** The trust agreement should absolutely state the governing law, and that statement could include the law that applies specifically as to validity, construction, and administration. But a simple statement of the governing law does not necessarily control. The governing law provision in the trust instrument generally controls "unless the designation of that jurisdiction's law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue." UNIF. TRUST CODE §107(1); RESTATEMENT (SECOND) OF CONFLICT OF LAWS §270 (addressing trust validity).

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

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

c. **Contacts.** If the governing law of another jurisdiction is selected, plan to have as many contacts as possible with that state, including location of the trustee, trust administration, and trust assets.

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

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

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

e. **Engage an Attorney in the Other Jurisdiction.** If a trust jurisdiction other than the settlor's (and attorney's) home state is selected, consult with an attorney in the selected jurisdiction. That might seem unnecessary, but if a problem arises, no one will care that the client did not want to hire an attorney in the other jurisdiction.

f. **Examples of Issues for Which Governing Law May be Important.** Examples of issues for which the governing law may vary significantly and which may assist or frustrate satisfying the settlor's goals include:

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

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

11. Trust Planning and Drafting Pointers

a. **Authorize Changing Trust Situs but No Duty to Monitor.** Including specific authority and mechanics for changing the trust situs provides very helpful flexibility, but state explicitly that the trustee has no duty to monitor continually whether other jurisdictions might be more advantageous for the trust (which is totally impractical for a trustee to monitor continually).

b. **Perpetuities.** Some states have abolished the rule against perpetuities (RAP) entirely (e.g., District of Columbia, New Hampshire, Maryland, Missouri, Rhode Island, South Dakota, and Virginia)) while others have extended the vesting period for a very long time (e.g., Tennessee [365 years], Nevada [360 years], Florida and Wyoming [1,000 years]). For a thorough discussion of "perpetual" trusts, see Fein, *A Defense of Perpetual Trusts*, 47 ACTEC L.J. 215 (Spring/Summer 2022).

  - Whether a settlor living in a state with a traditional RAP can create a trust in a state with an extended RAP and not be subject to the shorter RAP in the home state is unclear. The issue will likely turn on whether the RAP is a "strong public policy" of the home state. and that may be particularly problematic in those states that have constitutional provision prohibiting "perpetuities" (though some of those states have statutes that have significantly extended the perpetuities period). *See generally* Steven Horowitz & Robert Sitkoff, *Unconstitutional*

Perpetual Trusts, 67 VANDERBILT L. REV. 1769 (2014). The Restatement of Donative Transfers says that the rule against perpetuities is a matter of strong public policy. The Restatement (Second) of the Conflict of Laws (the trust provisions of which were drafted by Austin Scott) takes the position that the rule against perpetuities is not a strong public policy, but that the elective share is.

- Include a perpetuities savings provision in case the trust is moved to a state with a limited perpetuities period, the state changes the RAP, or the trust receives assets from a trust created in a jurisdiction with a shorter RAP.
- Segregate assets from separate trusts when a merger or other addition by modification occurs in case assets might be subject to different perpetuities periods.
- Be cautious in moving trust jurisdiction and governing law to a "perpetual trust state" if the original state has a RAP; it may work, but there are no guarantees.
- In very long-term trusts, building in flexibility for the trust is critical (for example, with decanting, trust modifications, powers of appointment, trust protector powers, etc.)

c. **Directed Trusts.** Several key structuring pointers include –

- Does the state have a directed trust statute; if so, following the statutory requirements closely and if not, consider carefully whether directed trust provisions in the instrument can override traditional trust law concepts that might limit the enforceability of such provisions.
- What level of nexus does the state require?
- Address whether the advisor giving direction acts in a fiduciary capacity (generally they should in order to assure that someone has fiduciary responsibility for every decision affecting the trust).
- Address the compensation of the direction advisors.
- Carefully define the scope of issues for which advisors can give direction and for which trustees are not responsible.
- Very carefully limit the responsibility and liability of trustees to review and monitor the activities of the direction advisor and for following directions from the advisor.
- Provide successor advisors or procedures for appointing successors.

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

- Include a trust provision allowing non-judicial resignation as well as removal and replacement of fiduciaries. See Item 34 below.
- Especially for long-term trusts, create procedures to always provide for the designation of successor trustees as needed.

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

- If the settlor's intent is that particular assets should be retained notwithstanding the lack of diversification, be as explicit as possible in negating a duty to diversify and relieving the trustee of liability for retaining assets.

- Some states have statutorily enhanced the protections for a trustee who does not diversify in accordance with the express terms of the trust agreement; other states recognize "purpose" trusts for holding non-diversified positions. *See generally* Schanzenbach and Sitkoff, *Risk Management and the Prudent Investor Rule*, 159 TR. & EST. 45 (Nov. 2020).

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

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

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

- Very specifically describe the scope of the protector's responsibilities and powers.
- Who to name as protector can be a difficult decision. The trustee is the most "trusted" person from the settlor's point of view, and the settlor needs "an even smarter and even more trusted person" to override the trust with the trust protector powers.
- Finding someone willing to serve may be very difficult, particularly if the protector acts in a fiduciary capacity considering potential liability for making broad changes to the trust.
- Address very explicitly whether the protector serves in a fiduciary capacity. Most of the statutes addressing trust protectors provide they are considered to act as a fiduciary unless the trust instrument provides otherwise (Delaware is an example of that approach). Respected planners have varying views about this issue. Some would generally not name trust protectors as fiduciaries in order to reduce the risk to them (if we think of protectors as standing in the shoes of the settlor, it may not make sense to make them a fiduciary in that role). Others would generally name protectors as fiduciaries and rely on exoneration in a trust instrument to exonerate the protector from liability except in the case of willful misconduct.
- The trust protector's standard of liability should be clearly stated in the trust agreement to avoid uncertainty.
- Address compensation of the protector.
- Having protectors who can "fix chaotic situations" can be critically useful.
- Having a protector with the flexibility to "fix chaotic situations" is not as important in a state that allows nonjudicial settlement agreements. They can permit an efficient alternative for making adjustments as needed.

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

g. **Trust Modification Flexibilities.** Tools available for nonjudicial modification of trusts include: (1) nonjudicial settlement agreements: (2) nonjudicial consent modifications; (3) decanting; and (4) dividing trusts. See Item 34 below for additional discussion about trust modification issues.

(1) **Governing Law.** The governing law of a trust determines which tools are available and who are necessary parties to the modification. Changing the place of administration might be possible to change the governing law to a state that allows a tool that is particularly favorable in a given situation.

(2) **Necessary Parties.** The necessary parties to implement a modification under each of the tools vary depending on the tool but consist of some combination of (1) the settlor, (2) the trustee, and (3) beneficiaries (or under the Uniform Trust Code, qualified beneficiaries).

(3) **Representation.** Because the consent of beneficiaries is typically needed in nonjudicial modifications (other than decanting), having a way to represent minors or unborn beneficiaries is often the key required element to complete a nonjudicial modification.

- The representative must not have a conflict of interest with respect to the particular question at issue in the modification.
- In addition, a settlor may never represent a beneficiary in a nonjudicial consent modification.

(4) **Decanting.** About 30 states have enacted decanting statutes including 12 that have adopted the Uniform Trust Decanting Act. A few state courts have recognized a common law power to decant by the authority to make distributions for the benefit of a beneficiary (examples are Florida, New Jersey, and Massachusetts).

- The decanting power is exercised in the trustee's discretion, so is subject to the trustee's fiduciary duties.
- Consider adding explicit decanting powers in the trust agreement in case the trust is moved to a jurisdiction that does not have a decanting statute.
- Can a beneficiary be removed by decanting? Can decanting eliminate a mandatory right? Can a power of appointment (general or limited) be added by decanting?
- Is notice to beneficiaries allowed (or required)? Generally, do not require beneficiary consent (unless required by the applicable state statute) because beneficiary consent may result in undesired tax effects to the consenting beneficiary.

(5) **Resources.** For a discussion of substantive law effects of the various nonjudicial modification alternatives, see Items 66-75 of ACTEC 2012 Summer Meeting Musings found **here,** and tax effects of trust modifications are discussed at Item 18 of Heckerling Musings 2017 found **here** and Items 42-51 of ACTEC 2015 Annual Meeting Musings found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

- Beneficiaries serving as trustee must be limited to a health, education, maintenance, and support (HEMS) distribution standard or the beneficiary will have a general power of appointment under §2041. *See generally* Christian Kelso, *But What's an Ascertainable Standard? Clarifying HEMS Distribution Standards and Other Fiduciary Considerations for Trustees*, 10 EST. PLAN. & COMMUNITY PROP. L.J. 1 (Fall 2017).
- Allowing "independent" trustees (at a minimum someone other than a beneficiary) to make distributions using a broader standard (even "in the discretion of the trustee") can add helpful flexibility in the administration of the trust.
- Naming a co-trustee to serve with the beneficiary can be very helpful if the trust instrument restricts the beneficiary/co-trustee from participating in any decision to make distributions to himself beyond an ascertainable HEMS standard. As long as the beneficiary has no right to succeed to the powers held by that co-trustee, the broad distribution powers of the co-trustee will not be imputed to the beneficiary (except perhaps in very unusual cases).

- Use a "savings clause" that automatically restricts the beneficiary from taking any actions that might possibly be construed as a personal benefit, unless those actions are limited by a HEMS standard, and to provide that any such actions would be taken only by the co-trustee. If no co-trustee is acting, the beneficiary/trustee could take steps to have the next successor trustee appointed as a co-trustee for the sole purpose of making that decision. (Some states automatically limit distributions by a beneficiary-trustee to a HEMS standard. *E.g.*, FLA STAT. §736.0814(2).)

- Specifically address whether outside resources reasonably available to a beneficiary should, should not, or "may but need not" be considered in distribution decisions. State laws vary on that issue, and the trust agreement can eliminate the uncertainty. The Comments and Reporter's Notes to Section 50 of the Restatement (Third) of Trusts summarizes the diversity of state law regarding the consideration of outside resources if the trust instrument is silent on the issue. The approach used should not affect whether a beneficiary has a general power of appointment. *See* Treas. Reg. §20.2041-1(c)(2) ("immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised"); §25.2514-1(c)(2). It is *very important* that settlors understand that requiring the trustee to consider outside resources has real economic consequences and may limit the ability to make distributions.

- Discourage pot trusts for multiple beneficiaries. Mandating that beneficiaries share a pot of money is a perfect recipe for family resentment and dysfunction. Everyone wants more to make sure they at least get their fair share.

- With every trust, discuss whether the trustee should have the discretion to make distributions to charities (or to a specified charity). A charitable income tax deduction is not available to the trust unless the distribution is made pursuant to the governing instrument, and the IRS takes the position that a later trust modification to permit charitable distributions does not satisfy that requirement. (A possible way around that hurdle is that each partner of a partnership is entitled to an income tax charitable deduction equal to the partner's distributive share of a charitable gift by the partnership. Rev. Rul. 2004-5 provides that a trust which is a partner will benefit from such flow-through charitable deductions even if the trust itself has no charitable beneficiaries.)

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

- Avoid mandatory distributions or withdrawal rights.

- Use a fully discretionary distribution standard in the sole and absolute discretion of a third-party trustee.

- Even with a fully discretionary standard, if the trustee follows a regular pattern of distributions, a court may view the distribution pattern as a marital property right or may consider future anticipated distributions in determining how other marital assets will be divided between the spouses.

- Including multiple beneficiaries (i.e., a "pot trust"), waiving the trustee's duty of impartiality among beneficiaries, and giving someone the authority to expand the class of potential beneficiaries all further distance the rights of a beneficiary (including a beneficiary going through a divorce) to trust assets.

- Various goals of settlors must be balanced. For example, using "pot" trusts for multiple beneficiaries may conflict with a goal generally of not forcing family members to "share" trusts in order to avoid family conflicts, and the client will need to weigh which approach to use.

- Negate property rights. A trust might specifically state that a beneficiary's interest in the fully discretionary trust is not a property right but a mere expectancy, in case applicable state law does not expressly provide that result.
- Include a spendthrift provision to make clear (and convince the divorce judge) that creditors have no access to trust assets (even if an exception from spendthrift protection may ultimately apply for certain spousal or child support rights).
- Using a disinterested trustee is more protective than using the beneficiary or beneficiary's spouse as trustee.
- A trust provision might terminate or suspend a beneficiary's interest and powers over a trust if the beneficiary is a defendant in a lawsuit or a party to a divorce proceeding. Alternatively, a trust protector acting in a non-fiduciary capacity may have the power to terminate or suspend a beneficiary's interest in the trust in such circumstances.
- The trust could give a disinterested trustee the power to terminate or suspend a beneficiary's right to receive information about the trust, such as trust accountings or reports, if the trustee determines that receiving that information would not be in the beneficiary's best interest.
- Powers of appointment add significant flexibility, such as the ability to appoint the assets to someone other than the beneficiary going through a divorce or to remove the beneficiary's interest in the trust.

j. **Powers of Appointment.** Including powers of appointment exercisable by a beneficiary or someone other than a beneficiary affords substantial flexibility to react to changing circumstances.

- The powerholder of a power of appointment is not a fiduciary, which allows more flexibility in making changes to the trust's dispositive plan. (However, frequent exercises of a power of appointment during the settlor's lifetime may create more of an appearance of the settlor acting through the powerholder (and keeping powers over the trust that could arguably cause estate inclusion).)
- Another incredibly important feature of the power of appointment is that it is also a power of *dis*appointment.
- If there is any concern that it will be exercised by the particular powerholder in an improper way, require the consent of a non-adverse party to the exercise.
- Be aware that giving someone other than an adverse party an inter vivos power of appointment (during the grantor's life) may cause the trust to be a grantor trust under §674.
- For long-term dynasty trusts, giving beneficiaries a testamentary power of appointment to appoint assets among the settlor's descendants (other than to the beneficiary's estate) gives each generation the ability effectively to re-write or eliminate the trust, eliminating the settlor's "dead hand from the grave" control over the trust for generations to come.
- What law and jurisdiction applies to state law issues regarding the power of appointment — the situs of the creator of the power, the situs of the powerholder, or for testamentary exercise, the jurisdiction in which the will is probated (which could be different than the domicile of the powerholder)? The instrument could specify the governing law and jurisdiction to avoid uncertainty.
- The common law rule is that there is a presumption that a power of appointment is a general power of appointment. Consider clearly specifying in the trust instrument that a power is intended as a "limited (non-general) power of appointment" to overcome that presumption.
- Under the relation back doctrine, the exercise of a power of appointment is treated as a transfer by the donor. The relation back doctrine was relied on in *Self v. U.S.,* 135 Ct. Cl. 371 (1956), to conclude that the exercise of a limited power of appointment did not result in a gift by the powerholder – it was a transfer by the original creator of the power under state law principles. *But see Estate of Regester v. Commissioner*, 83 T.C. 1 (1984).

- Including spouses of beneficiaries as possible appointees of a power of appointment can be helpful. There may be a desire to be able to continue the trust for the benefit of a child's spouse after the child's death in a long-term marriage situation. If there is concern that this power might be abused, the settlor could specify that the power could be exercised only with the consent of a non-adverse party. The trust could say that it can be exercised only to create an income interest, or perhaps also allowing invasions for limited purposes, such as health or maintenance.
- Takers in default of the exercise of the power of appointment, to the extent that it is not exercised, should be listed. For a general power of appointment, if no takers in default are listed, the general rule is that the assets would pass to the powerholder's estate, not to the estate of the creator of the power. However, for a non-general power of appointment, if there are no takers in default, and if the power is not exercised, the assets would pass to the potential appointees if they are a defined narrow class, or otherwise to the recipients of the estate of the creator of the power.
- For a summary of an outstanding presentation by Jonathan Blattmachr at the 2012 Heckerling Institute on Estate Planning about a wide variety of important state property law and federal tax law concepts regarding powers of appointment and helpful planning recommendations in using powers of appointment, see Item 8 of Heckerling Musings 2012 and Other Current Developments (April 9, 2012) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

k. **Communication.**

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

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

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

12. Estate Planning for the Middle Rich

These observations and planning tips are based on a seminar by Turney Berry and a panel discussion by Turney Berry, Robert Kirkland, Suzanne Walsh, and Melissa Willms at the 57th Annual Heckerling Institute on Estate Planning™. An overview of some planning tips is highlighted in this section. For a more detailed discussions of transfer planning issues, see Item 13 below.

a. **Middle Rich Definition.** For purposes of this summary assume the "rich" are individuals with a net worth of about $11 million (that's roughly the top 1% of households in the U.S.), and the middle rich are individuals with about $25 million or couples with about $50 million. The mega-rich are above that. (But much of this discussion applies to clients with far less wealth than that.)

   These definitions depend on what Congress does with the federal estate tax basic exclusion amount. If it remains at $10 million (indexed) (currently about $13 million), that means a couple with twice that (or about $26 million) can avoid federal estate tax with "simple" planning (using portability). But if the exclusion is reduced to $5 million (indexed) in 2026 (say $6-7 million), the estate tax for a couple will apply to estates over about $13-14 million.

b. **Overview of Planning Approach.**

   (1) **Who Do You Represent?** Thinking carefully about who you represent and having appropriate engagement letters is a key starting point.

   (2) **Scope of Engagement.** Are you being asked to do general estate planning or a specific project?

   (3) **Gathering Information.** Some planners request clients to fill out information in advance of the first meeting. Other planners like to talk with clients to obtain that information – "to hear what they say about their children and how they say it, to hear the dialogue between the spouses," etc. Among other things, be sure to get information about assets that pass by beneficiary designation automatically to coordinate those assets with the rest of the plan.

   (4) **What the Plan Will Cost.** Estate planning provides great value to clients. "Telling them what it will cost is a signal of how valuable the information is…You want the bourbon that is more expensive because it is more expensive."

   (5) **Address Non-Tax Nature of the Overall Plan, Governance.** Focus on the client's goals aside from tax planning. Is the primary purpose to assist the beneficiary in managing assets and also helping with asset protection, spousal insulation, etc. (beneficiary controlled or at least advised governance), or does the client want the beneficiary to be protected by one or more third parties (third-party protector governance)? Structuring appropriate trust governance is a vital part of the plan.

   (6) **Start the Process.** Do not get so bogged down in decision-making that the client doesn't start to plan.

   Perhaps start with ancillary documents. Powers of attorney and health care documents have become more complicated over the years. The Uniform Health Care Decisions Act is coming, and it will require more decisions for our clients to make ("that we too often don't know how to give guidance about").

   Basic wills and revocable trust planning are the backbone of the "simple" plan. Appropriate tax planning should be included. Based on a variety of factors, the planner will need to decide whether the plan for a coup[e will rely on portability (outright to spouse, disclaimer trust, "one lung" plan with a QTIPable trust) or will incorporate bypass trust planning from the outset. See Item 5 of Estate Planning: Current Developments and Hot Topics (December 2014) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

   (7) **Transfer Planning with Trusts**. Next, START by creating a grantor trust and start to make gifts to it. One planner calls this generically a "Test Trust." For the client who wants a beneficiary advised plan, the child could serve as trustee and the client can observe how the child operates or have the child serve with a co-trustee. Parents can start giving away assets and feel what that's like. Also, having an "old and cold" trust can help for later planning.

   The backbone of transfer planning for clients will be to start making gifts to a grantor trust. Assets could be sold to the trust by the grantor. Future appreciation is removed from the estate.

(Clients think their assets will go up in value or else they would get rid of those assets.) Because this will be the backbone of a long-term transfer plan, carefully think through the dispositive and governance provisions of the trust, and build in flexibility for someone to make adjustments as necessary.

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

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

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

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

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

Another approach may be to name the donor's spouse as a potential discretionary beneficiary (or to give someone the ability to add the spouse as a potential beneficiary in the future). (This is referred to as spousal lifetime access trust – or SLAT – planning.) See Items 12.e and 13.g below.

(8) **KISS Principle.** "We can take care of most of our clients most of the time using well understood commonplace type things and leave the esoteric for special situations. Do not be afraid of doing that."

c. **Powers of Attorney and Health Care Documents.** Various planning tips –

- Do not allow the agent under a power of attorney to withdraw assets from a funded revocable trust. Allowing an agent to amend or revoke the revocable trust might also allow the agent to withdraw funds by revocation.
- Consider lines of succession (using one document, or multiple documents with the attorney as custodian or with an escrow agreement).
- Care facilities will generally want someone to have a power of attorney for the patient.
- Health care providers usually want to talk to *one* person about health care decisions.
- When students go to college, parents no longer have the power to give consent to medical treatment or access health information. Discuss with clients whether they want to have health care powers for the college-age children.
- Bear in mind that powers of attorney in the wrong hands can lead to elder abuse. Dana Fitzsimons (Atlanta, Georgia) refers to powers of attorney as "the most effective burglary tool since the invention of the crowbar."

d. **Powers of Appointment vs. Trust Discretion Over Distributions.** Flexibility can be achieved by (1) giving a power of appointment to someone to appoint trust assets to specified parties or (2) giving an independent trustee broad discretion to make distributions. An important distinction from a tax planning standpoint is that the holder of a power of appointment is not a fiduciary and the IRS could argue that repeated exercises (at the suggestion of the donor) results in estate inclusion as retained control over who can enjoy trust assets and income under §2036(a)(2). Cases have held that §2036(a)(2) does not apply to family direction from a donor or the donor's family to a trustee who is a *fiduciary. Estate of Goodwyn v. Commissioner*, T.C. Memo. 1973-153.

e. **SLATs.**

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

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

(2) **Donor Access If Donee Spouse Predeceases; Deferred Contingent Annuity.** The donee spouse (or someone else) may have the authority to appoint assets following the donee spouse's death that would be broad enough to appoint assets to a trust of which the donor spouse is a discretionary beneficiary. That raises potential "implied agreement" §2036(a)(1) issues as well as potential §2036(a)(2) and §2038 issues if the donor's creditors can reach the trust under the "relation back" doctrine. References to additional resources in Item 13.g below include discussions of the "relation back" doctrine in the context of SLAT planning.

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

f. **Reverse Estate Planning.** Consider making use of otherwise unused exclusion amounts of parents or other elderly relatives by giving them a formula testamentary general power of appointment over assets in the client's grantor trust (that perhaps has been leveraged by sales to the trust), but only up to the unused exclusion amount in the parent's estate. That would allow a basis adjustment at the parent's death and would allow the parent to allocate GST exemption to the trust to the extent it is not fully exempt. To limit the risk of an "inappropriate" exercise of the general power, the general power of appointment would be (1) a testamentary power to appoint to the parent's creditors, (2) subject the approval of a nonadverse party ("use Uncle Fred; he's a grouch and he says no to everything"), (3) of an amount that when added to all other assets does not exceed the powerholder's unused exclusion amount (4) without considering the marital or charitable deduction of the appointee's estate, but (5) only to the extent of assets with a fair market value in excess of basis (and perhaps with an ordering provision so that assets with the most appreciation would first be subject to the general power). Before using this approach, make sure the powerholder does not have creditor concerns and that the existence of the power will not cause a loss of access to government benefits. Melissa Willms refers to this as the "Accidentally Perfect Grantor Trust." For a detailed discussion, see Item 7.c of Estate Planning Current Developments and Hot Topics (December 2015) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** A similar formula general power of appointment could be used for other trust beneficiaries as well. See Item 19 below.

g. **Defined Value Clauses to Deal with Valuation Uncertainties.** The "middle rich" are probably reluctant to accept any uncertainty about possibly having to pay gift tax. Defined value formula transfer clauses may be used when transferring hard-to-value assets. See Item 13.c below.

h. **Intra-Family Loans.** Utilize the simplicity of intra-family loans using the §7872 rate, in effect creating a family bank.

- Loans should be bona fide and well documented.
- An exception for loans up to $100,000 limits the imputed interest that must be reported by the lender to the amount of the borrower's net investment income. §7872(d)(1).
- Term loans are easier to administer than demand loans because you don't have to deal with a floating interest rate.

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

Trusts that are treated as deemed owned trusts under §678 because of the deemed owner's right to withdraw all of the income (including capital gain income) of the trust are sometimes referred to a BDOTs. For a detailed discussion of the use of BDOTs, see Item 16 of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** *See also* Edwin Morrow, *Using Powers Over Income and Beneficiary Deemed Owner Trust (BDOT) Provisions to Reduce Trust Income Tax Burdens*, 47 TAX MGMT. ESTS., GIFTS & TRTS. J. No. 1 (Jan. 13, 2022); Edwin Morrow, *IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)* (October 2022) (very detailed 195-page excellent resource) available at **https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3165592**. However, it is not clear that transactions between the deemed owner and the trust will be treated as nonrecognition events under Rev. Rul. 85-13.

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

13. Transfer Planning, Defined Value Formula Transfer Issues, Adequate Disclosure on Gift Tax Return

a. **Window of Opportunity; Anti-Clawback Regulation.** The gift/estate exclusion amount is scheduled to revert from $10 million (indexed) to $5 million (indexed) in 2026, so an ever decreasing window of opportunity is available for making use of the larger exclusion amounts with lifetime gifts. 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.

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

c. **Formula Transfers.** In light of inherent valuation uncertainties, planners are now frequently using defined value formula transfers.

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

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

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

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

(d) **Price Adjustment** – Price adjustment clauses adjust the price rather than the amount transferred in a sale transaction (King; but McLendon and Harwood did not recognize price adjustment clauses; an advantage of price adjustment clauses is that a "re-transfer/re-titling" of assets is not required after the correct value is determined) (Example: "I hereby sell 100 shares of the Company in exchange for a promissory note with a principal amount of $[X] (which the parties believe to be equal to the fair market value of the shares). The term of the promissory note shall be [add note terms/interest]. If the fair market value of the shares as finally determined for federal gift tax purposes is greater or less than $[X], the principal amount of the note shall be adjusted to the finally determined value effective as of the date of the transfer. The parties intend for the sale to be at fair market value and that no gift result from the sale.").

(e) **Reversion** – Reversions to donor of excess over a specified value (*Procter*) is a condition subsequent approach that does NOT work. The clause in *Procter* provided that any amount transferred that was deemed to be subject to a gift tax was returned to the donor. It trifles with the judicial system, because any attempt to challenge the gift or raise gift tax defeats the gift. That said, the *Procter* doctrine does not invalidate all formula transfers. Since the 1944 *Procter* case, many other types of formula clauses have been blessed by the IRS and the courts (marital deduction clauses, GST formula allocations, split interest charitable trust clauses, GRAT annuity payments, and formula disclaimers, to name a few).

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

- Public Charity/Donor Advised Fund – This approach is more conservative than other alternatives; the recipient of the excess amount has a fiduciary obligation; this type of donee was blessed in *McCord*, *Hendrix*, *Petter*, and *Christiansen;*
- Private Foundation – This is more cumbersome because the self-dealing and excess benefit rules apply;
- Lifetime QTIPs – A gift tax return will have to be filed making the QTIP election before knowing what assets are in the QTIP trust; and
- GRAT (for both lifetime QTIPs and GRATs, consider having different trustees and some differences in the beneficiaries than of the trust that is the initial recipient of the formula transfer so that independent fiduciary obligations exist; it is not clear how a GRAT could meet the requirement to make annuity payments within 120 days of the due date for annuity payments during the period of uncertainty as to what assets have been conveyed to the GRAT).

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

(3) ***Wandry* Clause.** The *Wandry* approach is simpler because it does not involve a third-party recipient, but it loses the benefit of a third-party trustee with independent fiduciary obligations, and it could result in fewer shares being transferred. See Item 14 below for a discussion of IRS arguments made against a *Wandry* transfer in *Sorensen v. Commissioner*.

(4) ***Wandry* Transfer Combined with Formula Disclaimer.** Some planners using a *Wandry* formula transfer approach recommend that the trust agreement specify that any disclaimed assets will remain with the donor, and that the trustee or donee(s) immediately following the transfer execute a formula *disclaimer* of any portion of the gift in excess of the value that the donor intends to transfer. (Statutes in some states specifically authorize the validity of such a provision allowing the trustee to disclaim.) The rationale is that the regulations have always recognized formula disclaimers as being valid (Treas. Reg. § 25.2518-3(d), Ex. 20.) and the *Christiansen* case upheld a formula disclaimer, 586 F.3d 1061 (8th Cir. 2009). Even if the *Wandry* formula transfer for some reason fails to limit the gift, the formula disclaimer will prevent an excess gift. This is a strategy that may provide additional comfort for clients who are very averse to paying gift taxes when making transfers of hard-to-value assets.

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

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

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

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

(6) **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, the

shares that were not transferred because of the *Wandry* provision would be sold for a note as of the same date as the *Wandry* gift, with the price being determined by the finally determined gift tax value. See Joy Matak, Steven Gorin & Martin Shenkman, *2020 Planning Means a Busy 2021 Gift Tax Return Season*, LEIMBERG ESTATE PLANNING NEWSLETTER #2858 (February 2, 2021) (includes excellent suggested detailed disclosures for reporting a two-tiered *Wandry* transfer on a gift tax return and income tax return, including Schedule K-1 disclosures).

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

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

(8) **Some Planning Issues.**

- The IRS looks at these cases closely, but largely to determine whether the clause was implemented properly. No pre-arrangements should exist.
- Documentation should be consistent in all respects with the formula transfer. (See the discussion in Item 14.c(1)(a) below about documentation tips based arguments raised in *Sorensen v. Commissioner*.)
- With a *Petter* or *Wandry* type of formula (based on values as finally determined for gift tax purposes) it is essential that a gift tax return be filed.
- The recipient trusts should be grantor trusts; if adjustments are made following an audit, no income tax return amendments should be necessary because all of the income is taxed to the grantor in any event.

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

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. For a discussion of *Woelbing*, see Item 8.c(16) of Aucutt, *Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts* (July 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.
- **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 Planning and Audits.** Several planning issues for GRATs for consideration –

- One of the major advantages of GRATs is that a formula, based on the finally determined value of contributed assets, can be used to set the retained annuity payments, thereby "eliminating" the risk of a surprise gift upon the creation of a GRAT. (But see Item 23 below regarding CCA 202152018.)
- A GRAT can be structured so that no taxable gift results from its creation, so GRATs can be used by donors who have no gift tax exclusion remaining.
- When the GRAT funding is reported on a gift tax return, elect out of automatic GST allocation. (The estate tax inclusion period (ETIP) does not end until the GRAT term ends.)

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

- Do terms of the GRAT agreement comply with the §2702 regulations?
- Has the GRAT been operated in accordance with its terms?
- Are the assets contributed to the GRAT properly valued? (See *Grieve v. Commissioner,* T.C. Memo. 2020-58, CCA 202152018 in Item 23 below, and *Baty v. Commissioner* in Item 24 below).
- Is a consistent valuation methodology being used for the initial valuation and for annuity payment valuations or exercises of substitution powers? (Consider using a *Wandry* type formula approach for annuity payments or exercises of substitution powers, although the use of a *Wandry* clause will require the filing of a gift tax return.)
- Have all annuity payments been made timely?
- The IRS is taking a hard line on operational issues. IRS representatives in some cases have argued that the GRAT was not a qualified interest under an *Atkinson* analysis, similar to the position publicized in CCA 202152018 (which is discussed in Item 23 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) basic exclusion amount may want potential access to or potential cash flow from the transferred funds. Various planning alternatives for providing some potential benefit or continued payments to the grantor and/or the grantor's spouse are discussed in more detail in Items 14-25 of the Current Developments and Hot

Topics Summary (December 2013) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** 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.** *See generally* George Karibjanian, *Exploring the "Back-End SLAT" – Mining Valuable Estate Planning Riches or Merely Mining Fool's Gold?*, 47 TAX MGMT. ESTS., GIFTS & TRTS. J. NO. 6 (Nov. 10, 2022).

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

Section 2036(a)(2) and the "alone or in conjunction with" analysis has been the focus in the last several years following the *Powell* case. For a discussion of *Powell*, *Cahill*, *Morrissette*, and *Levine* regarding the §2036(a)(2) issue and for a table of discounts allowed in recent FLP/LLC cases, see Item 18 below.

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. **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.**

k. **Report Transactions on Gift Tax Returns with Adequate Disclosure; Approaches for Satisfying the "Appraisal Safe Harbor."** 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 §6501(c)(9), for which the preferable way is usually to use a safe harbor described in Reg. §301.6501(c)-1(f)(2) and (3). The IRS has been aggressive in applying the requirements very strictly to prevent the running of the gift tax statute of limitations. The adequate disclosure requirements are also discussed in Item 16.d below.

The "appraisal safe harbor" in the adequate disclosure regulations requires that the appraisal, among other things, contain "[t]he date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal." Reg. §301.6501(c)-1(f)(3)(ii)(A). If a donor wants to make a gift of a certain amount (or approximate amount), how does the donor proceed? As a practical matter, the appraisal cannot possibly appraise the asset as of the date of the gift and be delivered on the same day prior to the gift later in the day. Alternatives include:

- Use a *Wandry* transfer on the date of the gift and obtain an appraisal later appraising the asset as of that date (to determine an estimate of the units transferred before the value is finally determined for gift tax purposes).
- Use a *Nelson* formula transfer, transferring assets having a specific value as determined by an appraisal by a designated appraisal firm to be completed within, say, 90 days after the transfer. The IRS does not find that abusive. By the time the gift tax return is filed, the appraisal report will have been delivered and the precise number of shares that were transferred will be known and reported on the gift tax return. Obviously, that approach provides no protection against gift taxes in the event of an audit. The key distinction from 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, whereas the formula dollar value being transferred under *Nelson* is that the formula dollar value as determined by an appraisal withing 90 days of the gift. For a summary of *Nelson*, see Item 11 of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**
- Obtain an appraisal before the gift is made, transfer the number of assets required to equal the targeted gift amount based on the value in that appraisal, and negotiate with the appraiser to update the appraisal as of the actual date of the transfer. Most appraisals will do that for a small additional fee (assuming major economic changes have not occurred in the meantime).

l. **Gift Tax Return Preparation, Reporting Charitable Gifts.** Consider reviewing the instructions to Form 709 with each gift tax return that is prepared. Form 709 appears deceivingly simple, but it's not at all simple. In particular, pay attention to the adequate disclosure rules (as discussed immediately above).

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

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

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

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

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

> [a] specific number of nonvoting shares in FIREHOUSE RESTAURANT GROUP, INC., a Florida corporation (the "Company"), that have a fair market value as finally determined for federal gift tax purposes equal to exactly $5,000,000. The precise number of shares transferred in accordance with the preceding sentence shall be determined based on all relevant information as of the date of transfer in accordance with a valuation report that will be prepared by the Dixon Hughes Goodman, LLP ("DHG"), Jacksonville, Florida, an independent third-party professional organization that is experienced in such matters and appropriately qualified to make such a determination. However, the determination of fair market value is subject to challenge by the Internal Revenue Service ("IRS"). While the parties intend to initially rely upon and be bound by the valuation report prepared by DHG, if the IRS challenges the valuation and a final determination of a different fair market value is made by the IRS or a court of law, the number shares [sic] transferred from the transferor to the transferee shall be adjusted accordingly so that the transferred shares have a value exactly equal to $5,000,000, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or court of law.

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

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

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

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

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

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

b. **Issues.** Three issues were in contention. (1) Are the defined value formula gifts respected? At issue is whether the defined value approach approved in *Wandry v. Commissioner*, T.C. Memo. 2012-88 would be respected. (2) What is the appropriate fair market value of the shares on the dates of the 2014 gift and the 2015 sale? (3) Are penalties appropriate or should they be waived for reasonable cause?

c. **IRS Arguments for Refusing to Respect the Defined Value Transfers.**

(1) **The Donors Relinquished Dominion and Control of 9,385 Shares on 12/31/14.**

(a) **Facts Supporting.**

i. **Company Reporting.** The company reported that each trust owned 9,385 shares on its stock ledgers and on income tax returns. ***[Planning Observation:*** Include an "asterisked" explanation on the stock ledger and tax returns. Using "uncertificated shares" may facilitate this reporting.]

ii. **Distributions.** The trusts received pro rata distributions based on owning 9,385 shares. [***Planning Observation:*** Document in company records that distributions are based on the initially determined amount of shares, which could be adjusted based on finally determined gift tax values, and that the brothers and their trusts will make appropriate adjustments between themselves if the shares are changed.]

iii. **No Agreement with Trusts.** The trusts never agreed to transfer shares based on the defined value formula and did not countersign the stock powers, which described the transfers as defined value formula transfers. ***[Planning Observation:*** Have the trusts countersign the stock powers to specifically acknowledge the conditions under which they are receiving the stock transfers.]

iv. **Third-Party Buyer.** The trusts transferred 9,385 shares each to the third-party purchaser, who paid the trusts for those shares. ***[Planning Observation:*** Have the buyer acknowledge that the ownership of shares is based on the defined value formula transfers, but that the trusts and donors agree that collectively they own the 9,385 shares and transfer them to the buyer; if adjustments are made in the ownership of the shares, the donors and trusts will adjust the sales proceeds appropriately but acknowledge that the buyer can pay the purchase price attributable to the 9,385 shares to the respective trusts.]

(b) **Cow Analogy.** The IRS's Pretrial Memorandum includes this analogy to a defined value gift of cows.

> Consider that if a farmer agrees to transfer his son [*sic*] several cows worth $1,000 as finally determined for federal gift tax purposes, and the farmer's appraiser determines that five cows equal that value, then the transfer is for five cows. The son is now the owner of five cows. Years pass. The son breeds the cows and opens a barbeque stand. If a later gift tax examination finds that each cow was actually worth more, and that two extra cows had been included in the transfer, **nothing in the agreement would allow the farmer to take the two cows back. They were sold as barbeque.** The parties might be held to their agreement—a transfer of the number of cows as finally determined to equal $1,000 coupled with the possibility of the farmer getting something (barbeque?) in the event of a redetermination of value. But whatever it is, it won't be the cows transferred. And it might be nothing; the farmer may not pursue his claim, and if he does, he is now just a general creditor who must stand in line with all the other unsecured creditors of the barbecue operation.
>
> The farmer's use of a transfer clause that contemplates subsequent events does not change the fact that the transfer of the five cows was complete on the execution of the documents. This is the case even though the number of cows was indefinite until the initial appraisal was completed. [Citations omitted.] The transfer was of five cows, regardless of whether the transfer is structured as a gift or a sale.
>
> Under the farmer's transfer document, however, a redetermination of the value of a cow might give rise to a right of recovery against the son. But a right that is dependent upon the occurrence of an event beyond the donor's control, such as a later redetermination of value by federal authorities or the courts, does not alter the fact that the transfer is complete for gift tax purposes upon the execution of the documents. [Citations omitted.] The possibility that the farmer might get something back does not change the fact that he transferred five cows upon the execution of the documents, regardless of whether the transfer is structured as a gift or a sale. (Emphasis added.)

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

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

The taxpayers reside in Florida so the case would be appealable to the Eleventh Circuit Court of Appeals. The IRS cited an Eleventh Circuit case that referred to *Procter*. *TOT Property Holdings, LLC v. Commissioner*, 1 F.4th 1354 (11th Cir. 2021) (language in a conservation easement deed purporting to bring the easement in compliance with regulations held to be an unenforceable savings clause; clause presented "the same sort of catch-22 situation that leads to the trifling with the judicial process").

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

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

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

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

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

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

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

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

d. **Valuation.** The parties obviously had substantial differences in their valuations of the nonvoting shares. The experts used similar valuation approaches but applied significantly different risk adjustments and comparables. Also, the IRS disputed the use of "tax affecting" for valuing S corporation shares. ***[Observation:*** the IRS Pretrial Memorandum cited several cases that rejected tax affecting but did not cite the more recent *Estate of Jones v. Commissioner* case (T.C. Memo. 2019-101) that accepted a tax affecting analysis under the facts of that case.]

e. **Penalties.** The taxpayers argued that penalties should not apply because a three-prong test (described in *Neonatology Associates v. Commissioner*, 115 T.C. 43, 99 (2000), *aff'd*, (3rd Cir. 2002)) for the reasonable cause exception was satisfied: (1) the adviser was a professional with expertise to justify reliance, (2) the taxpayer provided accurate and necessary information to the adviser, and (3) the taxpayer actually relied on the adviser's judgment in good faith.

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

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

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

f. **Settlement.** A Stipulation of Settled Issues reached the following conclusions:

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

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

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

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

Observations:

(1) Because of the huge appreciation resulting from the sale in 2021, the brothers were probably highly motivated to be treated as having transferred 9,385 shares in 2014, and not have some of those shares treated as having been owned by the donors. Applying the defined value formula, based on the stipulated value of $1,640 per share, would have resulted in each trust receiving only about $87 million from the sale in 2021 rather than about $153 million.

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

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

(2) The values resulting from the settlement ($1,640 per share for the gift and $1,722 per share for the sale) were much closer to the IRS's position that the shares were worth about $2,000 per share than the donors' appraised value of about $500 per share. Query how much of that added value was attributable to not allowing tax affecting of the S corporation shares?

(3) The 10% negligence penalty under §6662(a) was applied to the 2015 transaction but not the 2014 transaction. Was this because the 2015 transfer was not reported on a gift tax return? Or perhaps it was because the sale price was based on an appraisal as of three months earlier if significant financial changes occurred during those three months (the stipulated per share value was increased by five percent from December 31, 2014, to March 31, 2015, representing a 20% annualized increase if that growth was extrapolated over a full year).

(4) By any measure, the transfer transactions were wildly successful from a transfer planning standpoint (unless the parents were concerned they had transferred too much!). For a gift tax of about $6.5 million, as of seven years later each brother had transferred $153 million minus the $2.9 million (approximately) note from the 2015 sale, or $150.1 million – reflecting an effective tax rate of less than 5%.

(5) Do not use the *Wandry* formula in the stock power in *Sorensen* as a template for drafting *Wandry* assignments. The assignment began with assigning that number of shares equal to a particular value as finally determined for federal gift tax purposes, but then continued on with language that arguably could be closer to a *Procter* transfer. Stick closer to the assignment language used in *Wandry*.

(6) As discussed in Item 14.c(1)(a) above, planning tips can be gleaned from the IRS arguments in *Sorensen* for structuring and documenting the transfer of shares in satisfaction of the formula assignment before the time that a final determination of gift tax value is made, including documentation regarding the stock ledger, distributions, and the sale to the third party as well as having the donee specifically acknowledge the formula transfer on the stock power.

15. Substance Over Form (and Related Doctrines) Attacks Against Transfer Planning Transactions

The following summary is of an excellent presentation by Carol Harrington (Chicago, Illinois) at the 57th Annual Heckerling Institute on Estate Planning™.

a. **Anti-Abuse Doctrines Overview.**

(1) **Historically Applied for Income Tax Purposes.** Anti-abuse doctrines have been applied in the past mostly in the income tax area, not for transfer tax purposes. These doctrines often do not apply in the transfer tax area. For example, a business purpose generally is not relevant for a gratuitous transaction. But anti-abuse doctrines are being applied increasingly for transfer tax purposes. The various doctrines overlap, are not well defined, and sometimes are not even referred to in cases by these various doctrinal names.

(2) **Substance Over Form.** The seminal anti-abuse case was *Gregory v. Helvering*, in which a taxpayer did a corporate reorganization of a corporation with a subsidiary holding appreciated shares, followed by a liquidation of the corporation, so the taxpayer could receive the shares but avoid a dividend that would have resulted from distributing the shares directly. This is the case with Judge Learned Hand's famous quote: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." 69 F.2d 809, 810 (2d Cir. 1934). Despite that taxpayer-friendly statement, Judge Hand concluded that the corporate reorganization that met all the technical reorganization requirements nevertheless would not be respected for tax purposes. The Supreme Court affirmed, finding that the reorganization had no business or corporate purpose, "was nothing more than a contrivance," and "was brought into existence for no other purpose" than to avoid the dividend tax. The reorganization and immediate subsequent liquidation "was in fact an elaborate and devious form of conveyance masquerading as a corporation reorganization, and nothing else… To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." 293 U.S. 465 (1935). From those famous statements have evolved various anti-abuse doctrines.

(3) **Step Transaction.** Multiple transactions are collapsed into a single transaction reaching the end result. Courts have applied the doctrine, sometimes referring to three alternative tests: (i) End-result test (the parties always intended to reach the end result), (ii) Mutual interdependence test (doing any of the steps would be fruitless without the completion of the series; there is no independent significance to intervening steps); and (iii) Binding commitment test (there is a legally binding obligation to complete the series of steps). *See Linton v. United States*, 638 F. Supp.2d 1277 (W.D. Wash. 2009) (discussed below); Chip, *The Economic Substance Doctrine*, 508-2d T.M. at III,D.

(4) **Sham Transaction Doctrine.** Closely related to the substance over form doctrine, this doctrine refuses to give tax effect to transactions having no substance and are thus a "sham." Carol Harrington summarizes: "Anything with the word 'sham' in it is not good." This doctrine can take various forms including a lack of any economic substance other than achieving tax benefits or a factual sham in which purported transactions never actually occurred.

(5) **Economic Substance Doctrine.** The transaction lacks economic substance other than tax benefits. In *Frank Lyon Co. v. U.S.*, 435 U.S. 561 (1978), the Supreme Court respected a transaction that had (i) a legitimate non-tax business reason and (ii) objective economic substance. The doctrine was codified for income tax purposes in §7701(o) (effective for transactions after March 30, 2010). Under §7701(o) a transaction has economic substance if (i) the transaction meaningfully changes the taxpayer's economic position and (ii) the taxpayer has a substantial purpose apart from federal income tax effects for entering into the transaction.

(6) **Business Purpose Doctrine.** The doctrine is a similar to the substance over form and economic substance doctrines. Transactions are not recognized if their only purpose is income tax reduction.

(7) **Legitimate and Significant Non-Tax Reason.** Closely related to the business purpose income tax doctrine is the test adopted in *Bongard v. Commissioner*, 124 T.C. 95 (2005), recognizing a contribution to a limited partnership as being "bona fide" for purposes of the bona fide sale for full consideration exception to §2036 if it has a legitimate and significant non-tax reason.

(8) **Limitations on Applying Anti-Abuse Doctrines Where Statutory Requirements Are Met.** In *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2017), the court, in very strong

language, *excoriated* the IRS for its attempt to apply substance over form to a Roth IRA transaction holding an interest in a DISC that the IRS acknowledged satisfied the statutory requirements and had economic substance.

> Each word of the "substance-over-form doctrine," at least as the Commissioner has used it here, should give pause**. If the government can undo transactions that the terms of the Code expressly authorize, it's fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is. "Form" is "substance" when it comes to law. . . . The words of law (its form) determine content (its substance). How odd, then, to permit the tax collector to reverse the sequence—to allow him to determine the substance of a law and to make it govern "over" the written form of the law—and to call it a "doctrine" no less.**
>
> . . .
>
> In the Commissioner's defense, a kernel of this idea does not come out of left field. As support, he points to a seventy-two-year-old opinion of the Supreme Court, [*Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945)] …
>
> As Court Holding suggests, the line between disregarding a too-clever-by-half accounting trick and nullifying a Code-supported tax-minimizing transaction can be elusive. Some cases from our court, fact specific though they are, offer hints of a broad reading of Court Holding, saying that the Commissioner may recharacterize transactions, even those with economic substance, if they have no "valid, non-tax business purpose." . . . Decisions from our sister courts also straddle the line between holding that the transactions were a sham and suggesting that the Commissioner has a broad power to recharacterize transactions that minimize taxes, though none of them holds that a tax-avoidance motive alone may nullify an otherwise Code-compliant and substantive set of transactions.. . .
>
> The Commissioner adds that the "critical point" of his argument is that the tax benefits Summa Holdings has enjoyed were "unintended by both the Roth IRA and DISC provisions." Appellee's Br. 45. He may be right. And he may be right that permitting these DISC–Roth IRA arrangements amounts to dubious tax policy. **But the substance-over-form doctrine does not give the Commissioner a warrant to search through the Internal Revenue Code and correct whatever oversights Congress happens to make or redo any policy missteps the legislature happens to take.** (Emphasis added.)

Similarly, Judge Foley's concurring opinion in *Knight v. Commissioner*, 115 T.C. 506 (2000), cautioned about applying the economic substance doctrine and business purpose doctrine in the transfer tax context.

> … The "willing buyer, willing seller" analysis merely establishes the value of a partnership interest, not whether the economic substance doctrine is applicable.
>
> A fundamental premise of transfer taxation is that State law defines and Federal tax law then determines the tax treatment of property rights and interests. See Drye v. United States, 528 U.S. 49 (1999); Morgan v. Commissioner, 309 U.S. 78 (1940). As a result, the courts have not employed the economic substance doctrine to disregard an entity (i.e., one recognized as bona fide under State law) for the purpose of disallowing a purported valuation discount.
>
> The application of the economic substance doctrine in the transfer tax context generally has been limited to cases where a taxpayer attempts to disguise the transferor or transferees…. [Citations omitted]
>
> Generally, the economic substance doctrine, with its emphasis on business purpose, is not a good fit in a tax regime dealing with typically donative transfers. Business purpose will oftentimes be suspect in these transactions because estate planning usually focuses on tax minimization and involves the transfer of assets to family members. If taxpayers, however, are willing to burden their property with binding legal restrictions that, in fact, reduce the value of such property, we cannot disregard such restrictions. To do so would be to disregard economic reality.

b. **Application of Anti-Abuse Doctrines in Transfer Tax Area.**

(1) **Reciprocal Trust Doctrine.** In *United States v. Estate of Grace*, 395 U.S. 316 (1969), spouses created virtually identical trusts for each other 15 days apart. The court agreed with the IRS that each spouse should be treated as creating the trust for his or her own benefit, resulting in estate inclusion for each spouse under §2036. Under this doctrine the Court required "only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries."

(2) **Reciprocal Powers.** Similarly, several courts have held that trusts created by separate donors with reciprocal powers could cause estate inclusion in each donor's estate (for example, under §2036(a)(2) or §2038). *Estate of Bischoff v. Commissioner*, 69 T.C. 32 (1977) (spouses created trusts for their grandchildren two days apart, with each spouse serving as trustee of the trust created by the other spouse; reciprocal trust doctrine applied because it merely identifies the true transferor and does not require the donors to have beneficial interests in the trusts); *Exchange Bank & Trust Co. v. U.S.*, 694 F.2d 1261 (Fed. Cir. 1982) (reciprocal trust doctrine applied to custodianships created by spouses with each spouse acting as custodian for the other's custodianship); Ltr. Ruls. 9235025, 9451059, Tech. Adv. Memo. 8019041; but see *Estate of Green v. Commissioner*, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine did not apply to powers).

(3) **Reciprocal Transfers.** In *Sather v. Commissioner*, 251 F.3d 1168 (8th Cir. 2001), three brothers and their wives each had three children. On the same day, the three brothers and wives created trusts for their own children and their six nieces and nephews, claiming nine annual exclusions each. The court applied the reciprocal trust doctrine, saying that the Tax Court had begun "calling it the 'reciprocal transaction doctrine' in the context of reciprocal indirect transfers outside the trust arena." Each brother and his wife were treated as having created trusts for their own children, allowing each only three annual exclusions. The court referenced the reciprocal trust doctrine as a subset of substance over form and also referenced steps of an integrated transaction.

Schultz v. United States, 493 F.2d (4th Cir. 1974) (A gave shares to his three children and to the three children of his brother B and on the same day B made similar gifts; court disallowed the multiple annual exclusions; "the primary purpose of the reciprocal transactions was for each brother to effect enlarged gifts to his own children").

(4) **Indirect or Conduit Transfers.** Various cases have recognized for transfer tax purposes, the "real" transferor for tax purposes where indirect or conduit transfers were involved.

Heyen v. Commissioner, 945 F.2d 359 (10th Cir. 1991) (decedent made gifts to 29 non-family members and 27 of the 29 immediately made re-transfers to the decedent's family members; annual exclusions were allowed only for the two recipients who did not make re-transfers).

Estate of Cidulka v. Commissioner, T.C. Memo. 1996-149 (decedent made 14 transfers of stock to his daughter-in-law from 1963-1982, which she immediately re-transferred to decedent's son; only transfers in 1980-1982 were in question and the court treated the gifts as gifts to the son, thus limiting the number of annual exclusions available; gifts were made to various persons in 1982 resulting in decedent owning a minority interest, and decedent's stock was immediately redeemed for a note; in determining the gift amount, the various gifts in 1982 and the decedent's stock that was redeemed were valued as majority interests; penalties were applied).

Estate of Bies v. Commissioner, T.C. Memo. 2000-338 (decedent made gifts of stock to daughters-in-law who immediately retransferred the shares to their husbands who were decedent's sons; annual exclusions were not allowed for the gifts to the daughters-in-law who were characterized as "merely intermediate recipients").

Brown v. U.S., 329 F.3d 664 (9th Cir. 2003) (husband and wives made gifts for which they made split gift election; in addition, husband gave wife check for exact amount of gift tax attributable to her one-half gift, which she paid to the IRS the following day; husband died within three years and check given to wife to pay gift tax on her gift was treated as gift tax paid by husband and includible in his estate under §2035(b) as gift tax paid on a gift within three years of death).

Smaldino v. Commissioner, T.C. Memo. 2021-127 (husband made gift of LLC units to wife which she transferred effective the following day to a trust for husband's descendants (to utilize wife's remaining gift exemption); wife testified that she made "a commitment, promise" that she would re-transfer the units to the trust; IRS argued that substance over form doctrine would "recharacterize multistep property transfers among related parties as indirect gifts between the persons who were determined to be, in substance, the actual donors and donees"; court concluded that husband never transferred any LLC interest to wife and the entire transfers to the trust were a gift from husband, which precluded use of the wife's exemption amount). See Item 22 below for further discussion of *Smaldino*.

See also Treas. Reg. 25.2511-1(h)(2,3,9) (examples of indirect transfers for gift purposes).

c. **Sales for Notes.**

Minnie E. Deal v. Commissioner, 29 T.C. 730 (1958) (decedent created trust and daughters paid for the remainder interests [before §2702] with notes, and the notes were forgiven over the following four years; this was a gift and not a sale; the notes given to purchase the remainder interest were not respected because the notes were never intended to be repaid).

Estate of Maxwell v. Commissioner, 3 F.3d 591 (2nd Cir. 1993) (mother transferred her residence to her son and his wife for notes and they leased the residence back to mother, mother forgave $10,000 from each lender over the years and forgave remaining principal amounts in her will; decedent never intended to collect the notes and they were not respected as consideration for the sale).

Stokes v. Commissioner, T.C. Memo. 1999-204 (taxpayer sold business to trust in exchange for a 30-year deferred private annuity; trust sold the business three weeks later and taxpayer alleged the trust had increased basis because of the private annuity so no income tax was owed; court determined that the sale for the private annuity was a sham and taxed the business sale proceeds to taxpayer).

d. **Loans.** A number of cases have discussed whether loans would be recognized for tax purposes. The key issue appears to be whether there was a reasonable expectation of repayment of the loan. Other factors mentioned in cases include, having a written promissory note, appropriate interest, fixed payment dates, security, a fixed maturity date, demand for repayment, actual repayment, ability to repay, and consistent records and tax reporting.

Miller v. Commissioner, T.C. Memo. 1996-3 (transfers purported to be loans but IRS argued that in substance each transfer was a gift; court concluded that "[t]he mere promise to pay a sum of money in the future accompanied by an implied understanding that such promise will not be enforced is not afforded significance for Federal tax purposes, is not deemed to have value, and does not represent adequate and full consideration in money or money's worth"; detailed analysis of nine factors to determine if loan was bona fide).

Estate of Carolyn W. Holland v. Commissioner, T.C. Memo. 1997-302 (debt from decedent determined not to be valid debt for estate tax deduction; no notes were issued by decedent, but that was not "a significant factor"; decedent did not have adequate assets to secure the debt; no fixed date for repayment; no demand for repayment and no payments before her death; income not sufficient to maintain decedent's lifestyle and repay her obligations; penalties upheld for deduction of the purported loans).

Bolles v. Commissioner, T.C. Memo. 2020-71 (reasonable expectation of repayment existed for some time but eventually became clear that borrower could not repay and after that date further notes given were not recognized as bona fide loans).

Estate of Moore v. Commissioner, T.C. Memo. 2020-40, *aff'd*, 124 AFTR 2d 2021-6604 (9th Cir. 2021) (purported loan from FLP to decedent did not result in a deductible debt for estate tax purposes; there was no promissory note, no interest charged or paid, no collateral, no maturity date, no payments made, and no demand for payments; purported loans from FLP to children were treated as gifts even though there were signed notes but the notes had no repayment schedule, no interest payments were made, the FLP never demanded repayment, there was no evidence the children had the resources to repay the loans, notes were not secured, comparable funding from another lender was unlikely, the children did not set aside funds to repay the note, and evidence that decedent wanted each child to receive $600,000 and attorney advised that "having [them] as a gift wouldn't be the best use of the tax laws"). In *Moore* the children testified that the attorney told them they never had to make payments. Carol's observation: "Don't say things like that, or when the family members are under oath, they may actually tell the truth."

e. **Retained or Reacquired Interests.** The form of a transaction may divest the decedent of all benefits from transferred property, but actual benefits may nevertheless be retained.

Estate of Marshall v. Commissioner, 51 T.C. 696 (1969), *nonacq.* 1969-2 C.B. xxvi (husband owed funds to his wife from a prior loan but paid the funds into a trust for the wife instead of repaying her and in consideration for establishing the trust she forgave the husband's note; wife will be treated as the grantor of the trust and trust assets were included in wife gross estate under §2036).

Estate of Shafer v. Commissioner, 749 F.2d 1216 (6th Cir. 1984) (decedent provided third parties with consideration to purchase real estate, which they then transferred to a trust for the decedent and his wife; "[t]he effect of the transaction … is merely to eliminate the intermediate step of the [decedent] receiving the land in fee; … the inclusion of circumvention of the intermediate step should not make a difference in the estate tax consequences of the transaction").

Estate of Du Pont v. Commissioner, 63 T.C. 746 (1975) (decedent transferred real estate to a corporation created to hold the property; one week later the corporation leased the land to decedent with the stipulation it be used as a horse farm, which resulted in rent that was three to four times less than fair market value; three months later, decedent gave the stock of the corporation to a trust of which the decedent was not a beneficiary or trustee; court found that the "lease [was] so structured that it hardly reflected the kind of bona fide transaction that would have been entered into by parties dealing with one and another at arm's length . . . We have very little doubt that an independent owner would have been completely unwilling to enter into such a comparatively long-term lease the rent for which was predicated upon its substantially diminished value as a horse farm"; the court concluded that "[u]pon consideration of the whole record, we are firmly convinced that the series of legal steps, beginning with the creation of Hall, Inc. . . . and concluding with the transfer of its stock in trust . . . comprised a single device, wholly lacking substance, by which the decedent attempted to divest himself of title to property without relinquishing his possession or enjoyment thereof.").

Lee v. United States, 57 AFTR 2d 86-1548 (W.D. Ky. 1986), *aff'd*, (6th Cir. 1987) (opinion not recommended for full-text publication) (decedent gave to his son stock in a corporation that purchased and improved realty; decedent retained no interest, but all dividends were paid to decedent and he reported income from properties owned by the company on his personal income tax return; "the decedent, having received the income from the transferred property, must have the value of the … stock at the time of his death in his gross estate").

Mahoney v. United States, 831 F.2d 641 (6th Cir. 1987), *cert. denied*, 486 U.S. 1054 (1988) (decedent gave note to father in return for his father's funding a trust in which decedent had an income interest; payments were made on the note with income from the stock [effectively a constructive transfer from the trust to the decedent]; "This court has emphasized that the term 'transfer' is not to be interpreted in a restrictive manner and should be interpreted to effectuate the purposes of section 2036(a).… Consequently, we conclude that although [the father] nominally created the Trust, the decedent must be considered the effective grantor of the Trust to the extent of his consideration"; portion of trust assets attributable to the decedent's note compared to the total value transferred to the trust was included in the gross estate under §2036(a)(1)).

Estate of Maxwell v. Commissioner, 3 F.3d 591 (2nd Cir. 1993) (mother transferred her residence to her son and his wife for notes but because of an implied agreement that the notes would not be repaid, the house was treated as transferred to the trust for no consideration; son and his wife leased the residence back to mother; appellate court agreed with Tax Court's determination that "decedent's use of the house following the transfer depended not on the lease but rather on an implied agreement between the parties that the decedent could and would continue to reside in the house until her death, as she actually did"; taxpayer argued "that the decedent's payment of rent sanctifies the transaction and renders it legitimate. Both arguments ignore the realities of the rent being offset by mortgage interest, the forgiveness of the entire mortgage debt either by gift or testamentary disposition, and the fact that the decedent was eighty-two at the time of the transfer and actually continued to live in the residence until her death which, at the time of the transfer, she had reason to believe would occur soon in view of her poor health"; residence included in mother's estate under §2036(a)(1)).

f. **Minority Discounts; Bifurcated Transfers.** Anti-abuse doctrines (such as the step transaction doctrine) have been considered in several cases to determine whether minority discounts would be disallowed in situations involving bifurcated transfers.

Estate of Murphy v. Commissioner, T.C. Memo. 1990-472 (decedent gave 0.88% of stock to each of her two daughters 18 days before her death, reducing her interest to 49.65%; court refused to allow a minority interest discount on her remaining stock; court applied substance over form rationale reasoning that decedent had "implemented a plan 18 days before her death with the sole and explicit purpose to obtain a minority discount"; "all concerned intended nothing of substance to change between the time of transfer and the time of death, and … nothing of substance did change"; no discussion of §2036, §2035, or family attribution but various other minority interest discount cases involving bifurcated transfers were considered).

Frank v. Commissioner, T.C. Memo. 1995-132 (two days before decedent's death, shares were gifted by son as agent under power of attorney to decedent's wife, reducing his ownership from 50.3% to 32.1% and leaving the wife with 31.7% ownership; IRS urged that the transfer should be disregarded under the substance over form doctrine to disallow a minority discount; taxpayer argued there was no tax avoidance plan; "if tax avoidance was the sole motive, a substantially smaller number of shares could have been transferred. We find it unnecessary to decide this dispute over the motive of the transfer. As a general rule, we will respect the form of a transaction. We will not apply substance over form principles unless the circumstances so warrant.").

Estate of Church v. United States, 85 AFTR 2d 2000-804 (W.D. Tex. 2000), *aff'd per curiam without opinion*, 268 F.3d 1063 (5th Cir. 2001) (family partnership created two days before decedent died unexpectedly; IRS claimed that "while the formation of the Partnership took the form of a bona fide business transaction, the transaction had no substance and was entered into for no purpose other than to reduce the taxation of the estate"; court reasoned the character of interests owned changed dramatically as a result of the partnership; "the Partnership had bona fide purposes and was not a sham as that term is used in estate taxation. I also find that the Partnership was not formed solely to reduce estate taxes.").

Griffin, Jr. v. U.S., 42 F. Supp. 2d 700 (W.D. Tex. 1998) (husband gave 45% of corporation to wife leaving him with 55%; one month later wife gave her 45% to trust for descendants and five days later husband gave 45% to the trust; both spouses claimed minority interest discounts on their gifts; government asserted that the transfer of shares to wife "was a sham solely intended to evade taxes" and that the court "should look to form over substance"; taxpayers argued that the substance over form doctrine should not apply to gift tax cases because there is no business purpose for gifts and that wife had no legal obligation to give the shares to the trust; "Gordon Griffin testified at trial that he intended to transfer a 90% interest in the corporation to the Trust and that he wished to minimize or extinguish his gift tax liability by dividing the stock into two separate, 45% interest transfers. He discussed his plan with Katherine Griffin before he transferred his stock to her. He spoke to his wife every night for one month to encourage her to transfer her shares to the Trust… It is beyond question, therefore, that the only purpose in the two transfers was to take advantage of the minority interest and marketability discounts. That the transfers were concocted in conjunction with Gordon Griffin's estate planning efforts (which the plaintiffs suggest is a legitimate, non-tax purpose) and that Katherine Griffin was under no legal obligation to transfer the stock to the Trust is irrelevant.").

Pierre v. Commissioner, T.C. Memo. 2010-106 (taxpayer gave 9.5% and sold 40.5% interests in LLCs to each of two trusts; step transaction doctrine applied to value the transfer to each trust as a combined 50% interest; "Petitioner intended to transfer two 50-percent interests to the trusts, but she first gifted small interests in Pierre LLC to use a portion of her then-available credit and her GST tax exemption. We find that petitioner had primarily tax-motivated reasons for structuring the gift transfers as she did…. We find that nothing of tax-independent significance occurred in the moments between the gift transactions and the sale transactions. We also find the gift transactions and the sale transactions were planned as a single transaction and that the multiple steps were used solely for tax purposes.").

g. **Minority Discounts; Indirect Transfers re Entity Contributions.** Various cases have involved the transfer of assets to a partnership or LLC after interests in the entity had been given to a donee. The IRS argued that this results in an indirect gift of the contributed asset to the other entity owners without a discount. The taxpayers in these cases often argue that such a transfer of assets to an entity results in the *contributing* owner's capital account being increased, so no gift results. The IRS responds that any such "transitory allocations to capital accounts" are merely steps in integrated transactions intended to pass the assets to the donees in partnership form.

Shepherd v. Commissioner, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002) (taxpayer transferred stock to a newly formed partnership owned 50% by him and 25% by each of his two sons; partnership agreement provided that any additional contributions would be allocated to all partners' capital accounts proportionately, not just to the contributing partner's capital account; court held that additional contributions were treated as gifts of undivided 25% interests in the contributed assets).

Several cases have held that no indirect gift results from additional contributions to entities that were allocated to the *contributing owner's* capital account. *Estate of Jones v. Commissioner*, 116 T.C. 121 (2001); *Gross v. Commissioner*, T.C. Memo. 2008-221.

In addition, several cases have held that no indirect gift results if contributions are made to the entity before interests in the entity are given because the step transaction doctrine would not apply if enough time lapses after the contribution that there was a "real economic risk" that the value of an LP unit could change during that period. *Holman v. Commissioner*, 130 T.C. 170 (2008) (partnership funded with Dell Computer stock six days before limited partnership units were transferred); *Gross v. Commissioner*, T.C. Memo. 2008-221 (2008) (contribution of "common shares of well-known companies" 11 days before gifts of partnership interests).

Various other cases, though, have treated contributions of assets to entities as indirect gifts of the contributed assets to the other entity owners, particularly if the taxpayer could not establish that contributions of assets to the entity occurred before the gift of interests in the entity or if the transactions happened the same day.

Senda v. Commissioner, T.C. Memo. 2004-160, aff'd, 433 F.3d 1044 (8th Cir. 2006) (no proof that partnership interest was transferred before the contribution of certain stock to the partnership and Tax Court reasoned that, "[a]t best, the transactions were integrated … and, in effect, simultaneous"; "taxpayers were more concerned with ensuring that the beneficial ownership of the stock was transferred to the children in tax-advantaged form than they were with the formalities of FLPs…[T]ransfers of stock … were indirect gifts of the stock to the children…. The gift tax thus shall be determined on the value of the stock rather than on the value of the partnership interests transferred"; Eighth Circuit affirmed, observing that even if contributions were allocated to the donor's capital account, "this formal extra step does not matter" because under the step transaction doctrine "formally distinct steps are considered as an integrated whole, rather than in isolation, so federal tax liability is based on a realistic view of the entire transaction").

Linton v. United States, 638 F. Supp.2d 1277 (W.D. Wash. 2009) (court finds indirect gifts of pro rata shares of the assets contributed to the LLC resulted under the reasoning of *Senda*; in addition, even if contributions to the LLC were made before gifts of the LLC interests, taxpayers still made indirect gifts under the step transaction doctrine; any of the three alternative step transaction doctrine tests would be satisfied – (1) binding commitment test because binding trust agreement and transfer documents were signed at the same time taxpayers contributed property to the LLC, (2) end result test because the taxpayers had "a subjective intent to convey as much property as possible to their children while minimizing their gift tax liability," and (3) interdependence test because taxpayers would not have taken one or more of the steps at issue "absent their 'contemplation of other integrating acts'").

Heckerman v. U.S. 104 AFTR 2d 2009-5551 (W.D. Wash. 2009) (contribution of marketable assets to LLC and transfer of LLC units occurred on the same day; treated as indirect gift of the assets based on holding in *Senda*; in addition transfer of the marketable assets and gifting of LLC units "were, at best, integrated and, in effect, simultaneous" and the contribution and gifting of LLC units "is properly characterized as an integrated transaction in which Plaintiffs indirectly gifted the cash to the children's trusts" under the step transaction doctrine; step transaction doctrine applied – end result test and interdependence test are satisfied, under reasoning similar to that in *Senda*).

h. **Minority Discounts Disallowed by §2036 Inclusion.** About 40 cases, beginning in 1997, have discussed whether assets in a limited partnership or LLC interest should be valued with appropriate discounts or if the value of assets in the entity should be included in the gross estate under §2036 valued without discounts. Earlier cases touched on various reasons analogous to substance over form/step transaction issues. For example, cases referred to commingling of funds, testamentary characteristics, being on both sides of the transaction, no pooling of assets with others, merely change form in which the interest is held, and circuitous recycling of value. The major issues were crystalized in *Estate* of *Bongard v. Commissioner*, 124 T.C. 95 (2005), recognizing a contribution to a limited partnership as being "bona fide" for purposes of the bona fide sale for full consideration exception to §2036 if it has a legitimate and significant non-tax reason.

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.**

i. **Avoiding Anti-Abuse Doctrines – Practice Pointers.**

(1) **Time.** A recurring theme is to allow time between many of the transactions. The longer the better. Some cases have said 12-15 days is enough to avoid the step transaction doctrine (*Holman*, *Gross*), but that is really pushing it. Clients will want to do it as soon as possible – "but he may change his mind," yes, but that's precisely the reason it works.

(2) **Formalities.** In the substance vs. form test, at least get the "form" right – for example, with actual signed trust documents, actual transfers, maintained capital accounts, bank accounts owned by the entity, etc. Do things in the right order (e.g., sign the trust before transferring assets to the trust).

(3) **Compliance and Reporting.** Compliance and reporting should be consistent throughout. The IRS often looks for glitches in reporting (including tax reporting) of the transaction.

(4) **Play Fair**. You must follow the rules – no side agreements.

(5) **No Prearrangements.** Don't have a prearranged plan, especially avoid prearranged "re-transfers." Avoid even the appearance of a prearrangement to the extent possible.

(6) **Coercion.** No threats or intimidation. (For example, in *Griffin, Jr. v. U.S.*, the husband spoke with his wife "every night for one month" to encourage her to re-transfer shares.)

(7) **"Steps."** Do not say "Step 1, Step 2" in a flowchart.

(8) **Disclosure.** The planner must balance the desire to have written documentation of full exposure of risks of the transaction with not providing a roadmap to the IRS of how to attack the transaction. At the planning stage, proceed with the mindset that the IRS or a judge will someday see everything you put in writing. But, as Carol puts it: "We don't go to jail for anyone."

(9) **Follow-Up.** The client must be willing to have periodic follow-up to make sure the proper formalities and reporting are being carried out.

(10) **Pattern.** No pattern of consistently taking actions that suggest an implied agreement or prearrangement.

16. Ethics and Privilege Landmines with Gifts and Form 709

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

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

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

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

b. **Privilege Issues.**

(1) **"The Privilege."** The attorney-client privilege is often referred to as "the privilege." It is an evidentiary rule, not an ethics rule, protecting an attorney's legal advice from disclosure in discovery.

(2) **Client Waiver.** Only the client (not the attorney) has the authority to waive the privilege. However, an inadvertent disclosure by the attorney may waive the privilege (in which event the attorney would have to consider the attorney's ethical duties to the client).

(3) **Contrasting Ethical Rule of Confidentiality.** Model Rule 1.6 requires that attorneys not disclose confidential information, including the identity of clients. The lawyer's duty to maintain confidences is an ethical duty, and violations can give rise to a cause of action against the attorney. The attorney-client privilege is an evidentiary doctrine, typically defined by statute. Communications subject to the confidentiality restriction are not necessarily privileged. Under certain circumstances, the duty of confidentiality may be waived.

(4) **Waiver of Privilege Often Is Needed in Transfer Tax Cases.** The taxpayer has the burden of proof and burden of production in tax cases. Often the taxpayer needs evidence of advice from the attorney to establish needed elements of a defense. For example, establishing a defense to a §2036 attack based on the bona fide sale exception may be facilitated by the attorney's contemporaneous records regarding the legitimate and significant nontax reasons for creating an entity. Also, the attorney's tax opinion may be essential to establishing a reasonable cause exception to an undervaluation penalty. As a result, the planning attorney should operate under the assumption that everything said or written by the attorney will eventually be seen by an IRS attorney or a judge.

(5) **Communications With Non-Client Family Members.** Disclosures to anyone other than the client can waive the privilege. If a family member arrives at the attorney's office with a client, the attorney could ask the client to wait in the waiting room until needed, or the family member may

be appointed as an agent to assist on the tax planning matters. (Use a power of attorney very narrowly limited to tax issues.)

(6) **Other Matters Not Covered by the Privilege.** Other documents and communications not covered by the privilege include –

- The attorney's work papers (though they may be protected by the work product doctrine).
- Correspondence or communications with third parties.
- Attorney bills and invoices (disclose enough to convince the client to pay the bill but not problematic details; for example, "consider section 2036 issues" is ok, but do not add details about why section 2036 might apply).
- Tax return preparation advice.
- Dual purpose business and tax advice; if the business advice is not the primary purpose of the advice, the advice might not be protected.
- Tax opinions arguably are not privileged.
- Delivery method could be available to third parties (one court said that putting documents in a Drop Box account caused loss of the privilege; "the more you can meet and deliver advice in person, the better").

(7) **Kovel Letters.** The privilege may apply as to an outside person that has helpful information to assist the attorney representing the client if the person has a particular skill the attorney does not have. The attorney should send the individual a "Kovel letter" engaging the person to assist the attorney. Requirements include (i) hiring a consultant, (ii) at the attorney's direction, (iii) not just for return preparation work, (iv) with an agreement that the work belongs to the attorney, (v) to assist in delivering legal advice. Pre-Kovel communications are likely not privileged.

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

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

(8) **Appraisers.**

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

c. **Disclosing Risks to Clients.**

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

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

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

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

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

d. **Adequate Disclosure.** In order to be assured that the 3-year statute of limitations has started for assessing additional gift tax, the gift tax return must meet the adequate disclosure requirements of §6501(c)(9) and Reg. §301.6501(c)-1(f)(1). The IRS has been aggressive in applying the requirements very strictly to prevent the running of the gift tax statute of limitations. Some return preparers include an adequate disclosure statement on the gift tax return, explaining in detail how all the requirements of the regulation are satisfied. Stephanie Loomis-Price recommends including an adequate disclosure statement on Form 709. It is not required, and some of the requirements are not totally objective. She recommends complying with the regulation, "but let the IRS ask you about it if they think something is wrong." See Item 13.k above for more discussion about the adequate disclosure requirements.

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

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

f. **Form 2848, Power of Attorney.** A danger with having Form 2848 for taxpayers based on prior matters is that the Form stays on file until the attorney withdraws as the attorney of record, and communications from the IRS for the taxpayer may be sent to the attorney (and perhaps sent to an old address for the attorney). A CAF 77 listing is a complete listing of all clients for a given representative under that CAF number and may be obtained via a Freedom of Information Act (FOIA) request. The web address for a CAF 77 request is: **https://www.irs.gov/privacydisclosure/freedom-of-informationact-foia-guidelines**. The practitioner should notify the CAF function in writing if there is a change of address. A request for withdrawing from representation must be in writing, list all tax matters and period, and contain the representative's signature and date.

17. Installment Sales

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

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

"Taxable Installment Note" and "IDGT Installment Note" will be used to differentiate between the two different sale transactions.

a. **Installment Method Basics**. The installment method for deferring income first appeared in the Revenue Act of 1926 and is currently addressed in §453, §453A, and §453B.

(1) **Gains, Not Losses.** The installment method is only available for transactions that result in a gain to the seller; it is not available for transactions that result in a loss.

(2) **Payment Elements.** Under the installment method, each payment received by the seller is comprised of: (1) a nontaxable return of basis, (2) a portion of the realized gain, and (3) taxable interest.

(3) **Basis.** The buyer immediately receives cost basis in the property, notwithstanding the deferred payment obligation.

(4) **Deductibility of Interest.** If the buyer is related, the interest paid will likely be treated as nondeductible personal interest under §163(h). If the buyer is not related, the interest paid is deductible.

(5) **Interest Rate.** While there are no requirements related to deferring or varying principal payments, interest charged must be at least the applicable federal rate under §1274(d) to avoid a portion of each installment being treated as imputed interest under §1272-§1275.

(6) **Term of Note.** The IRS has ruled that if the duration of the note is equal to or greater than the seller's life expectancy, then the obligation will be taxed as an annuity under §72 instead of the preferred installment method. GCM 39503 (5/19/86).

(7) **Types of Qualifying Transactions.** The installment method is not available in certain transactions, including but not limited to, sales of marketable securities, dispositions by dealers of property, or the sale of depreciable property to related buyers.

b. **Electing Out.** Section 453(d)(1) says that if a transaction qualifies as an installment sale, it will be taxed pursuant to the installment method as a default unless the seller elects out. A seller may prefer to elect out of the installment method for several reasons, such as: (a) wanting to offset the gain with unused losses; (b) planning for an expected increase in capital gain tax rates; (c) reducing the taxable estate (by the tax liability paid); or (d) eliminating items of IRD from the estate.

c. **The Interest Charge and Pledge Rules.** Section 453A outlines two special installment method rules applicable to nondealers for transactions where the sales price exceeds $150,000:

(1) **Interest Charge Rule.** The Interest Charge Rule applies if the "obligation is outstanding as of the close of such taxable year," and the face amount of "all such obligations held by the taxpayer which arose during, and are outstanding as of the close of, such taxable year exceeds $5,000,000." §453A(b)(2). Important for planning purposes is the fact that the IRS has ruled that the Interest Charge Rule is applied at the owner level as opposed to the entity level for partnerships and other pass-through entities. IRS Notice 88-81, 1988-2 C.B. 397. In addition, TAM 9853002 ruled that spouses are treated as separate taxpayers for purposes of the $5 million threshold. If the obligation is subject to the Interest Charge Rule an amount is added to the taxpayer's tax liability for that year that is calculated pursuant to §453A(c)(2) and reported on Line 15 of Schedule 2 of Form 1040. The amount due will decrease over time unless tax rates rise in the future, or the obligation is interest-only with a balloon payment of principal at the end of the term.

(2) **Pledge Rule.** Section 453A(d)(1) provides that if a taxpayer pledges an installment obligation as security for a loan, then the net proceeds from such loan will be treated as a payment received on such installment obligation. As noted earlier, one reason a taxpayer may not wish to utilize the installment method is if the taxpayer anticipates that capital gains tax rates will go up in the future. If a taxpayer is holding an installment obligation and would like to accelerate the income for that same reason (and the buyer is unable or unwilling to pay off the note early), the taxpayer

could intentionally trigger the Pledge Rule by borrowing funds and pledging the installment obligation as collateral.

d. **Resale Rule.** Section 453(e) states that if a taxpayer sells property to a related person under the installment method (the "first disposition"), and the related person then disposes of the property (the "second disposition") within two years and before making all payments to the original seller, the amount received by the related party on the second disposition is treated as payment received by the original seller in the first disposition (with limitations). If the second disposition is not a sale, the fair market value of the transferred property is substituted for the amount realized. § 453(e)(4). Under §453(e)(5), if the second disposition results in a deemed payment to the original seller, future payments received by the original seller are not treated as amounts received until the total of such actual payments received surpasses the deemed receipt triggered by the second disposition.

e. **Transfers at Death.** Generally, death-related transfers are not taxable dispositions. A Taxable Installment Note is IRD and no basis adjustment is allowed under §1014. One situation in which there is a taxable disposition at death is if the obligation is distributed to the obligor on the note. A transfer by way of a joint tenancy with rights of survivorship is not a taxable disposition. If the estate made the sale, however, in return for a note, a subsequent transfer of the note from the estate to beneficiaries generally would cause the transferor immediately to recognize any remaining gain that has been deferred by the installment reporting method. §453B(a).

f. **Losing Grantor Trust Status.** What happens to outstanding IDGT Installment Notes when grantor trust status is lost? If grantor trust status is lost while the note is outstanding, the obligation transforms from an IDGT Installment Note into a Taxable Installment Note on the effective date of the status change, and the rules of §453, §453A, and §453B now apply.

(1) **Grantor Trust Status Terminated While Grantor Living**. The basis of an IDGT Installment Note becomes important if grantor trust status is lost during the grantor's lifetime or if the grantor transfers the note. However, we have no guidance about whether an IDGT Installment Note has basis or what that basis might be. Paul concludes "that the only sensible answer is the IDGT Installment Note can only have an adjusted basis equal to the property that was exchanged in the installment sale to the IDGT." Paul's paper also walks through various examples analyzing the basis of an IDGT Installment Note in the event grantor trust status is turned off after the sale, the grantor gifts the IDGT Installment Note after the sale, and the grantor substitutes assets after the sale and thereafter terminates grantor trust status.

(2) **Grantor Trust Status Terminated at Grantor's Death.** An IDGT Installment Note will not be considered IRD like a Taxable Installment Note upon the death of the grantor while the note is outstanding. It is not possible for an IDGT Installment Note to be IRD as long as Revenue Ruling 85-13 remains effective, since IRD can only include amounts that would have been taxable "in the hands of the decedent if the decedent had lived and received such an amount." Section 691(a)(3). Instead, the IDGT Installment Note should be entitled to a basis adjustment upon the death of the grantor under §1014. The beneficiaries receiving the note will therefore be shielded from recognizing gain as they receive payments on the now Taxable Installment Note. However, the interest will be taxable.

(3) **Other Issues.** Numerous other issues that arise upon the termination of grantor trust status and the conversion from an IDGT Installment Note to a Taxable Installment Note include:

(a) **Imputed Interest.** If interest on the IDGT Installment Note was at the AFR but AFR rates are higher at the time of the conversion, the holder of the obligation may have imputed interest at the higher AFR.

(b) **Interest Charge Rule.** The Interest Charge Rule likely applies to the Taxable Installment Note, requiring additional payments based on the deferred tax.

(c) **Pledge Rule.** The Pledge Rule likely applies as well.

(d) **Ineligible Transaction.** Immediate gain may be triggered if the assets sold were ineligible for installment method treatment, such as marketable securities.

(e) **Taxable Disposition.** The taxable dispositions rules in §453B will apply, and a gift of the Taxable Installment Note will result in a taxable payment to the holder of the note at the greater of face value or fair market value.

(f) **Basis Adjustment.** The Taxable Installment Note will be ineligible for the basis adjustment under §1014 and will instead be considered IRD at the death of the holder.

g. **Planning with Partnerships.** Paul believes planning for installment obligations should be focused on the use of partnerships. His outline contains various techniques, including but not limited to:

- As noted above, the $5 million threshold for the Interest Charge Rule is applied at the partner level, as opposed to the partnership level. Therefore, a partnership can be used to multiply the threshold by the number of partners, enabling the partnership to reduce or avoid the additional charge when utilizing installment sales for high value property.
- It may be possible to avoid triggering the Pledge Rule if the Taxable Installment Obligation is owned by a partnership, and the partnership interest is pledged as opposed to the obligation itself.

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

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

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

b. **Section 2036(a)(2).** In a few cases, the IRS has also made a §2036(a)(2) argument, that the decedent has enough control regarding the FLP/LLC to designate who could possess or enjoy the income or property contributed to the entity. Two cases have applied §2036(a)(2) where the decedent had some interest as a general partner (*Strangi* and *Turner*), and one case applied §2036(a)(2) when the decedent held merely a limited partnership interest (*Powell*, as discussed in Item 18.c immediately below).

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

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 there is not an opinion following a trial.)

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

(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 20.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 20.b below for a discussion of *Estate of Levine*.

d. **What to Do? Planning After *Powell*.** For a discussion of planning alternatives to avoid the *Powell* broad application of §2036(a)(2) under the "in conjunction with" reasoning, see Item 8.c-e of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

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

Case	Assets	Court	Discount from NAV/ Proportionate Entity Value
Strangi I	Securities	Tax	31%
Knight	Securities/real estate	Tax	15%
Jones	Real estate	Tax	8%; 44%
Dailey	Securities	Tax	40%
Adams	Securities/real estate/minerals	Fed. Dist.	54%
Church	Securities/real estate	Fed. Dist.	63%
McCord	Securities/real estate	Tax	32%
Lappo	Securities/real estate	Tax	35.4%
Peracchio	Securities	Tax	29.5%
Deputy	Boat company	Tax	30%
Green	Bank stock	Tax	46%
Thompson	Publishing company	Tax	40.5%
Kelley	Cash	Tax	32%
Temple	Marketable securities	Fed. Dist.	21.25%
Temple	Ranch	Fed. Dist.	38%
Temple	Winery	Fed. Dist.	60%
Astleford	Real estate	Tax	30% (GP); 36% (LP)
Holman	Dell stock	Tax	22.5%
Keller	Securities	Fed. Dist.	47.5%
Murphy	Securities/real estate	Fed. Dist.	41%
Pierre II	Securities	Tax	35.6%
Levy	Undeveloped real estate	Fed. Dist. (jury)	0 (valued at actual sales proceeds with no discount)
Giustina	Timberland; forestry	Tax	25% with respect to cash flow valuation (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%

Case	Assets	Court	Discount from NAV/ Proportionate Entity Value
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).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(4) triggering the "Delaware tax trap."

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

(2) **Drafting Considerations.**

(a) **Manipulation; *Kurz v. Commissioner*.** Consider whether the beneficiary could manipulate the beneficiary's taxable estate (for example, by leaving the beneficiary's estate to a spouse or charity) to increase the amount of the trust over which the beneficiary would have a general power of appointment. If so, the IRS might argue that the beneficiary has a general power of appointment to that maximum extent. *See Kurz v. Commissioner*, 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995). However, *Kurz* makes clear that contingencies that have independent significant non-tax consequences are to be ignored. Those contingencies prevent the decedent from having realistic unfettered control to access the trust assets. As to the possibility of a marital or charitable bequest increasing the amount of the general power of appointment under the formula, such bequests would seem to have independent significance. However, to avoid that argument, the formula could refer to an amount "determined for this purpose without regard to any available charitable or marital deduction." For a more detailed discussion of the *Kurz* case and the possible implications for formula general powers of appointment, see Item 7.e of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.bessemer.com/professionalpartners.**

(b) **Specifying Assets Subject to the General Power.** Consider describing particular assets over which the power of appointment applies (for example to include only appreciated assets, or to provide an ordering of assets so that particular assets with high appreciation that are likely to be sold early or assets with the highest percentage appreciation would be first in order). Without such a provision, the general power may apply to a pro rata portion of all trust assets. See Ed Morrow, *PLR 202206008: Judicial Settlement Modification & Formula Testamentary General Powers of Appointment*, LEIMBERG ESTATE PLANNING NEWSLETTER #2946, at n.2 (March 17, 2022).

(c) **Limiting "Inappropriate" Exercise.** To limit the possible "inappropriate" exercise of a power of appointment, (1) state that some independent person has the ability to remove the general power of appointment before the powerholder dies or to revise the power (for example, to adjust a formula general power of appointment), (2) specify that the power is exercisable only with the consent of some other non-adverse party (but not the grantor), *see* Reg. §20.2041-3(c)(2), Ex. 3, and (3) limit the permissible appointees of the power (such as to persons related by blood, marriage, or adoption or to creditors).

(d) **Flexibility.** Beyond limiting "inappropriate exercise," giving a non-adverse party the ability to modify the general power of appointment (mentioned immediately above) adds significant flexibility to react to changing circumstances. An added advantage is that the holder of the general power of appointment would not have a vested interest if the power can be modified by a third party, so actions by the powerholder reducing the pool of assets subject to the power would not constitute a release of a general power of appointment resulting in a gift by the powerholder.

(e) **Using Beneficiary's GST Exemption.** If another purpose of granting the general power is to utilize the powerholder's GST exemption, structure the formula to be based on the lesser of the individual's remaining GST exemption or applicable exclusion amount.

(f) **Avoiding Need for Powerholder to File Estate Tax Return.** Consider limiting the formula to $10,000 less than the powerholder's applicable exclusion amount so that the existence of the general power of appointment will not require the powerholder's estate to file an estate tax return.

(g) **Sample Forms.** For examples of formula powers, see *Ed Morrow & the Optimal Basis Increase Trust (OBIT)*, LEIMBERG ESTATE PLANNING NEWSLETTER #2080 (March 20, 2013). An updated version is downloadable for free from **the ssrn.com website**. 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.**

(h) **Power to Appoint to Creditors.** A method of limiting the manner in which a general power could be exercised is to provide that the power may only be exercised in favor of creditors. For an excellent discussion of the effect of a general power to appoint to creditors, and whether the power could be exercised only up to the amount of debt to a particular creditor, and the impact of that decision on the amount included in the gross estate under §2041, see Robert J. Kolasa, Creditor General Powers of Appointment, Trusts & Estates 16 (Feb. 2020).

(i) **Creditor Effects.** Bear in mind that the existence of the general power may have creditor effects, but the actual exercise of a testamentary general power of appointment may be more likely to subject the assets to the decedent-beneficiary's creditors than if the general power is not exercised. Section 502 of the Uniform Power of Appointment Act provides that creditors of the holder of a general power may reach the assets subject to the power to the extent the powerholder's property (if the power is *presently exercisable*) or the powerholder's estate is insufficient. This is the biggest change from traditional law principles under the Uniform Power of Appointment Act, and this is the provision of the Uniform Act that states are most likely to consider changing.

(j) **Similar PLRs.** Other PLRs that have addressed formula general powers of appointment include PLRs 200604028 and 200403094.

20. 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 immediate access to the cash surrender values. *Estate of Morrissette v. Commissioner*, 146 T.C. 171 (2016). The court entered several Orders denying the taxpayer's motions for summary judgment that §2036(a)(2), §2038(a)(1), and §2703(a) do not apply and denying the IRS's motion for summary judgment regarding those sections because a material factual dispute existed 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 very brief summary of the analysis in *Estate of Cahill* about §2036, §2038, and §2703, see Item 18.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 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 excellent summaries of this second *Morrissette* opinion (sometimes referred to as "*Morrissette II*") and of general planning issues involving intergenerational split-dollar life insurance, see Todd Angkatavanich, James Dougherty, Eric Fisher & Nickolas Davidson, *Lessons From* Levine *and the Not-So-Illusory Fiduciary*, TRUSTS & ESTATES at 18 (November 2022); 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 most important factor 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." 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. The court accepted the IRS's proposed termination date of three years after the estate tax return was filed. 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.

(4) **Penalties.** While reliance on professional advice may provide a reasonable cause defense if the reliance was reasonable and in good faith, the court determined 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 TODAY FEDERAL (June 9, 2021).

The court did not criticize the professional appraiser's credentials or experience as a professional appraiser. 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 *Estate of Michael Jackson* case (T.C. Memo. 2021-48), 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).

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

(2) **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 Government argued that under state law the settlors of a trust with the consent of its beneficiaries may terminate the trust and revest the transferred property in the donor. A "persnickety textualist" may say that is a power in conjunction with others that would trigger §2036(a)(2) or §2038, but the Supreme Court in *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.

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

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.

(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."

(3) **Observations.**

(a) **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.

(b) **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.

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

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

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.

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

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

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

b. **Validity of the "Protected-in-Perpetuity" Conservation Easement Regulation (At Least Regarding Improvements).** 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. Many conservation easements provide that upon termination or extinguishment of the easement the grantee would receive from the proceeds an amount reduced by the increase in value attributable to improvements made after the grant of the easement, which is inconsistent with the regulations. *E.g.*, *Belk v. Commissioner*, 774 F.3d 221 (4th Cir. 2014). 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 on subtracting the value of post-donation improvements in determining the portion of extinguishment proceeds attributable to the easement is arbitrary and capricious and violates the procedural requirements of the APA. *Hewitt v. Commissioner*, 21 F.4th 1336, 128 AFTR 2d 2021-7033 (11th Cir. December 29, 2021).

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

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

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

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

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

> Judge Toro explained that the "Treasury received more than 700 pages of comments" during the comment period and that, in the final regulations, Treasury responded to those comments and other administrative matters in just two of the twelve pages—"six columns in the Federal Register"—consisting of the final regulations. *Id.* at 221. In his view, it was likely that Treasury "was simply following its historical position that the APA's procedural requirements did not apply to these types of regulations," noting that the final regulations referenced Treasury's belief that they did not require notice and comment and that this belief was mistaken. *Id.* at 222.
>
> Judge Toro then found that the "Treasury failed to 'respond to "significant points" and consider "all relevant factors" raised by the public comments.'" *Id.* at 223 ... The proposed regulations' preamble explained that they reflected Congress's "major policy decisions," and NYLC "in effect countered that the proposed rule on future donor improvements was contrary to those policy decisions, would lead to inequitable results that were inconsistent with the statute, and would deter future contributions." *Id.* at 225 (quoting 48 Fed. Reg. at 22,940). In other words, Judge Toro found that NYLC "offered comments that, 'if adopted, would require a change in an agency's proposed rule,'" and that "were both 'relevant and significant,' [as to] require[e] [sic] a response." *Id. ...*
>
> ... Judge Toro also explained that the *Oakbrook* majority's reasoning as to the issue was flawed for several reasons. He explained that courts were "not required to 'take the agency's word that it considered all relevant matters,'" as the majority asserted. *Id.* at 226–27 (quoting *PPG Indus., Inc. v. Costle*, 630 F.2d 462, 466 (6th Cir. 1980)). He further noted that "[a] 'relevant and significant comment' requires a response, regardless of whether the point is made by many, a few, or even a single commenter," and "a comment does not lose its significance because it is presented succinctly." *Id.* at 227 (quoting *Carlson*, 938 F.3d at 347). And, if the scope of the project "was too large to permit an appropriate response to all 'relevant and significant comments,' then Treasury could have broken the project down into smaller parts." *Id.*

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

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

Commentators have emphasized the significance of this case as representing "one of the few successful challenges to a Treasury regulation on procedural grounds." Miller & Chevalier Tax Alert, *In Case You Missed It: Hewitt v. Commissioner Has Broken New Ground in Disputes Over*

Conservation Easements (January 19, 2022), available at **https://www.millerchevalier.com/publication/case-you-missed-it-hewitt-v-commissioner-has-broken-new-ground-disputes-over.**

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

The U.S. solicitor general decided not to appeal *Hewitt* to the Supreme Court, despite the circuit split in light of the Sixth Circuit's contrary holding in *Oakbrook Land Holdings, LLC*, discussed immediately below.

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

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

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

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

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

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

Oakbrook filed a petition for certiorari with the Supreme Court on October 4, 2022, which the Supreme Court denied on January 9, 2023. *See* Kristen A. Parillo, *Taxpayer Pushes for End to Circuit Split on Easement Reg Validity*, 177 TAX NOTES FEDERAL 300 (Oct. 10, 2022); Mitchell A.

Kane, *The Dispute Over Perpetual Conservation Easements Just Got Worse*, 177 TAX NOTES FEDERAL 1211 (Nov. 28, 2022).

(3) ***Glade Creek Partners LLC v. Commissioner*, Eleventh Circuit.** The Eleventh Circuit vacated for reconsideration the Tax Court's denial of a $17.5 million easement deduction in *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2020-148 based on its opinion in *Hewitt* but upheld the Tax Court's application of the substantial valuation misstatement penalty. *Glade Creek Partners LLC v. Commissioner*, 21 F.4th 1336 (11th Cir. 2021).

(4) ***Sparta Pink Property, LLC v. Commissioner*, Tax Court (Appealable to Eleventh Circuit).** The Tax Court denied the IRS's motion for partial summary judgment regarding the IRS's denial of a conservation easement deduction for failure to comply with the "protected in perpetuity" regulation (because of "carve-outs for 'donor improvements'"). The motion was denied in light of *Hewitt* because the case is appealable to the Eleventh Circuit. The motion was denied "without prejudice to [the IRS's] submission of the arguments set forth therein should subsequent developments warrant that action." *Sparta Pink Property, LLC v. Commissioner*, T.C. Memo. 2022-88 (August 29, 2022).

(5) ***Long Leaf Property Holdings LLC v. Commissioner*, Tax Court (Appealable to Eleventh Circuit).** The Tax Court, in an Order dated August 31, 2022, has held in abeyance a Motion for Partial Summary Judgment based on alleged invalidity of the "judicial extinguishment" regulation until the Eleventh Circuit provides further guidance regarding the scope of its *Hewitt* opinion. Judge Lauber reasoned that it is unclear whether *Hewitt* invalidated the regulation in its entirety or only as to its disallowance of a deduction based on carve-outs for donor improvements. The issue in *Long Leaf* involved limiting the donee's share of extinguishment proceeds to a fixed historical value *(i.e.*, the easement's fair market value on the donation date), not donor improvements. *Long Leaf Property Holdings LLC v. Commissioner*, Dkt. No. 11982-16 (Petition filed May 19, 2016). *See* Kristen A. Parillo, *Clarity Needed on Scope of Court's Easement Reg Opinion*, TAX NOTES TODAY FEDERAL (September 1, 2022).

(6) ***Battelle Glover Investments LLC v. Commissioner*, Tax Court (Appealable to Eleventh Circuit).** Similarly, the Tax Court, in an Order dated September 12, 2022, vacated its earlier order sustaining the denial of an approximate $150 million easement deduction based on the *Hewitt* decision invalidating the "judicial extinguishment" regulation under the Administrative Procedure Act. The case would be appealable to the Eleventh Circuit Court of Appeals. *Battelle Glover Investments LLC v. Commissioner,* Dkt. No. 6904-19 (Order dated Sept. 12, 2022).

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

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

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

(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) ***Green Valley Investors, LLC v. Commissioner*.** Notice 2017-10 identifies as "listed transactions" what are commonly referred to as syndicated conservation easement transactions in which promotional materials offer prospective investors in a pass-through entity the possibility of a charitable contribution that equals or exceeds an amount that is two and one-half times the investor's investment. In a **15-2 full Tax Court decision,** the court granted summary judgment for the taxpayer, holding that Notice 2010-7 is invalid under the Administrative Procedure Act. *Green Valley Investors, LLC v. Commissioner*, 159 T.C. No. 5 (November 9, 2022) (reviewed by the Court). The opinion reasoned that Notice 2017-10 is a legislative rule, that it was improperly issued by the IRS without notice and comment as required under the APA, that it will be set aside for this case, and that penalties under §6662A will not be imposed. The opinion relied heavily on *Mann Construction, Inc. v. United States*, 27 F.4th 1138 (6th Cir. March 3, 2022), *rev'g* 539 F. Supp. 3d 745 (E.D. Mich. 2021).

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

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

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

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

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

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

(4) ***GBX Associates, LLC v. United States,* Northern District Ohio.** A district court opinion filed five days after *Green Valley Investors* allowed relief against the IRS's use of Notice 2017-10 on the basis that *Mann Construction, Inc. v. United States* had invalidated a different IRS Notice for failure to comply with the APA. (The Ohio case would have been appealable to the Sixth Circuit, which decided the *Mann* case.) The court refused, though, to grant the GBX's request for a "universal vacatur," by which Notice 2017-10 would be held unlawful – or "vacated" – in its entirety, not just as applied to GPX. The opinion observed that the Third, Ninth, and D.C. Circuits have agreed that the APA authorizes universal vacatur, but neither the Supreme Court nor the Sixth Circuit has. It also noted that the IRS is continuing to contest in other jurisdictions that IRS Notices are subject to the APA notice and comment requirements. *GBX Associates, LLC v. United States*, 130 AFTR 2d 2022-6440 (N.D. Ohio, Nov. 14, 2022).

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

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

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

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

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

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

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

The IRS published the safe harbor deed language in Notice 2023-30. Easement donors have 90 days from April 24, 2023 (i.e., until July 24, 2023), the date the safe harbor language is published in the Internal Revenue Bulletin, to substitute the new safe harbor language in their original deeds. IRS Newswire Issue Number IR-2023-73 (April 10, 2023).

(c) **Penalties.** In addition, the statute strengthens accuracy-related penalties for these transactions by (i) treating any disallowance under these rules as a "gross valuation misstatement," which doubles the penalty under §6662 from 20 percent to 40 percent, (2) eliminating any reasonable cause defense under §6664(c), and (3) eliminating the requirement for supervisory approval of penalty assessment under §6751(b).

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

(7) **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.
>
> ...
>
> As recent cases like *Mann Construction*, *CIC Services*, and *Liberty Global* show us, courts keep encouraging Treasury and the IRS to join the mainstream of administrative law principles. It is unclear how developments will evolve and to what extent other courts will follow suit. What is clear, however, is that momentum continues to build behind APA challenges, and the recent run of taxpayer wins suggests that the government's traditional defenses against these challenges are no longer tenable. We anticipate that more taxpayers will press APA claims, as is their right. The government has a lot of old guidance that may be vulnerable. The situation is not sustainable from a tax policy perspective.

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

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

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

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

> Taxpayers will be emboldened to challenge the IRS and Treasury's rulemaking authority because of the judiciary's growing suspicion of the exercise of administrative power by the executive branch, [Eric Solomon] predicted.
>
> [He] … explained that the courts have increasingly taken the view that the executive branch is overstepping its bounds regarding regulations and that Congress should be writing the rules instead.
>
> Noting that Justice Neil M. Gorsuch has indicated that he would like to revisit the *Chevron* doctrine, which set forth that if the statute isn't clear, an IRS interpretation that is reasonable within the law will be allowed, Solomon said that "taxpayers are going to challenge exercises of regulatory authority by the IRS as exceeding the IRS authority."
>
> "They're going to say, 'Congress should have done this. The IRS has gone beyond its limits and therefore the regulations violate the *Chevron* decision,'" said Solomon…. Or the Supreme Court might rewrite the *Chevron* rules to say that the IRS is entitled to less deference, he said.
>
> Solomon said taxpayers are also asserting that regulations are running afoul of the Administrative Procedure Act, which requires regulations to go through a notice and comment procedure.

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

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

22. 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).

For a detailed discussion of *Smaldino*, see Item 20 of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

b. **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).

For a more detailed discussion of these reciprocal transfer and indirect transfer cases, see Item 15.b above.

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 effective as of the next day as in *Smaldino*); analogy to the indirect gift/step transaction analysis of the *Holman* line of cases regarding indirect gifts of 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.

23. 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...

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

(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.

Under 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 a perceived lack of any good faith effort 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, that 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 penalty 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*, 174 TAX NOTES FEDERAL 1142 (FEB. 21, 2022).

d. ***Baty v. Commissioner.*** In a similar Tax Court case, the IRS maintained that because the taxpayer intentionally undervalued stock contributed to a GRAT (by not taking into account pending merger discussions), the taxpayer was not able to take advantage of the GRAT provisions. The IRS eventually conceded that case. *Baty v. Commissioner* is discussed in Item 24 immediately below.

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

In this Tax Court case (the case addressed in CCA 201939002), the IRS maintained that because the taxpayer intentionally undervalued stock contributed to a GRAT (by not taking into account pending merger discussions), the taxpayer was not able to take advantage of the GRAT provisions. The IRS eventually conceded. *Baty v. Commissioner*, Tax Court Docket No. 12216-21 (Petition filed June 23, 2021, Stipulated Decision Entered June 17, 2022).

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 maintained, 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 repeated 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 Chief Counsel's office was pushing a novel position and placed significant reliance on some older assignment of income cases of all things. The CCA cited two cases involving corporate mergers or reorganizations for authority that the value should be determined after taking into consideration the anticipated merger. *Silverman v. Commissioner*, 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 process of reorganizing with intent to go public; court rejected expert testimony that failed to consider circumstances of anticipated future public sale); *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999), *aff'g,* 108 T.C. 244 (1997) (taxpayer was officer and director of corporation of which board of directors had approved a merger agreement; after merger was "practically certain to go through" but before actual merger occurred, taxpayer gave shares to charities; when charities sold shares, taxpayer realized gain under 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 maintained 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 pointed 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 cited 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, **no** 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 was 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 took 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).

f. **Concession.** The IRS sought and was granted a two-month extension to respond to the motion for summary judgment. Before entering a response, the IRS conceded, and a stipulated decision was entered on June 17, 2022. (The valuation facts appear worse for the taxpayer in CCA 202152018 than in *Baty*. The IRS's concession in *Baty* does not necessarily portend a concession in the underlying case involved in CCA 202152018.)

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

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

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

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

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

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

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

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

b. **General Background Regarding Effect of Insider Trading Restrictions on GRAT Planning.** Section 16(b) of the Securities Exchange Act of 1934 permits recovery by a corporation of insider trading profits made within a 6-month period. Under the §16(b) "short-swing profits" rule, profits must be disgorged if any sales and purchases by an insider occur within six months of each other. A contribution to a GRAT is arguably a "sale," and a distribution of insider stock in satisfaction of the annuity payment is arguably a "purchase" by the grantor. If a corporate insider funds a GRAT with the corporation's stock, will the return of some of the stock to the grantor (in satisfaction of an annuity payment) trigger a 6-month insider trading test period? A 1997 SEC No-Action Letter held that the creation of a GRAT and subsequent return of stock to the grantor in satisfaction of annuity payments will "effect only a change in the form of beneficial ownership without changing a person's pecuniary interest in the subject equity securities." Accordingly, such a transaction would be ignored for § 16(b) purposes under that No-Action Letter. *Peter J. Kight*, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 77,403 (October 16, 1997). However, cases (discussed below) have held that the substitution of insider stock and an unauthorized transfer from a GRAT of insider stock for the benefit of insiders constituted purchases for purposes of § 16(b).

If the grantor/corporate insider exercises a power to substitute property of equal value for some of the stock in a GRAT during its term, one court held that the substitution constitutes a "purchase" for §16(b) purposes, thus creating a six-month period during which any profits from subsequent sales of such stock would have to be disgorged to the corporation. *Morales v. Quintiles Transnational Corp.*, 25 F. Supp. 2d 369 (S.D.N.Y. 1998). In *Quintiles*, the taxpayer sold the shares within 6 months from the date of the reacquisition under the substitution power for more than $1 million. The District Court ordered the taxpayer to surrender the $1 million profit to the corporation. The case was appealed to the Second Circuit Court of Appeals, but was settled prior to hearing, and the appeal was withdrawn.

In *Dreiling v. Kellett*, 281 F. Supp.2d 1215, 1244 (W.D. Wash. 2003), the court imposed a $247 million damage award, as a result of determining that distributions from a GRAT constituted a "sale."

See generally Ellen Harrison, *Case Studies – Implementing Bright Ideas*, 38th ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING ¶1902.5 (2004).

At the 44th Annual Philip E. Heckerling Institute on Estate Planning in January 2010, the late Mil Hatcher advised that the estate planner must work with securities attorneys in making these decisions. Also, the estate planner would have to coordinate with the company's inside counsel and its outside counsel. A particular problem is that receiving insider stock in satisfaction of the annuity payment and rolling the stock into a new GRAT may be treated as a purchase and sale within six months. "If three securities attorneys look at it, I assure you there will be at least two different answers." The securities attorney may not be willing to opine that the distribution of insider stock in satisfaction of an annuity payment is definitely not a §16(b) transaction. Mil quipped that "securities lawyers will have all kinds of problems. It's nice to know that someone is more paranoid than we are."

c. **Planning Considerations Regarding Swaps with GRATs in Light of *Donoghue v. Smith*.** It seems prudent to assume that any substitution of assets transaction (and especially where the settlor is not the trustee) would constitute a "purchase" of securities that could be matched with any actual sale of securities in a market transaction or private third-party transaction, and shares should not be sold in a market transaction or private third-party transaction within six months of any substitution of assets transaction.

   Our Bessemer colleague, Dana Fitzsimons (Atlanta, Georgia) advises that he makes it a regular practice in situations involving acquisitions of stock under substitution powers in GRATs to preview securities law issues with company counsel to obtain some assurances that the company would not view the substitution of assets in a GRAT as a "purchase" of securities from the GRAT and a "sale" of securities by the GRAT (and would not be viewed as being matchable with another substitution of assets transaction for short-swing profit liability purposes).

d. **Warning Regarding Potential Section 16(b) Transactions.** Dana Fitzsimons gives the following sage advice regarding the importance of being very careful in planning whenever potential short-swing profit transactions with corporate insiders may occur. He notes that David Lopez, one of the attorneys for the plaintiff in the *Donoghue* case, is frequently involved in these types of cases:

   > The process by which short-swing profit liability is found and short-swing profits are required to be disgorged commonly is initiated by David Lopez, a New York plaintiff's lawyer who acts on behalf of one or more shareholders of numerous issuers. There may be other plaintiff's lawyers in this area, but I've dealt with David Lopez on several occasions for multiple clients. I understand that Mr. Lopez maintains and monitors a computer database of Section 16 filings on behalf of the shareholders of numerous issuers. When his computer finds a possible purchase and sale of an issuer security within a six-month period, he generates a letter to the issuer demanding that any associated short-swing profit be disgorged. The issuer then will need to investigate the claim (if it has not already done so) and report the results of that investigation to Mr. Lopez. If the issuer's investigation confirms that there is a short-swing profit, the issuer would demand disgorgement of the profit from the insider and Mr. Lopez generally would then be entitled to a finder's fee based on the amount collected (which I believe would be equal to 10%-25% of the total short-swing profit). If the issuer's investigation does not support a finding of a short-swing profit, that may be the end of the story. However, Mr. Lopez could then initiate a lawsuit to seek a judgment finding such a profit and compelling its disgorgement (which action he may be particularly enticed to pursue if the size of the potential short-swing profit is significant). In either case, I suspect that it would be helpful to the insider's position if the issuer were to determine that the facts at issue do not support a finding of short-swing profit liability (even though such a finding would not necessarily preclude Mr. Lopez from pursuing continued recovery efforts).

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

26. Checks Written Before but Cashed After Death Includable in Estate, *Estate of DeMuth v. Commissioner*, T.C. Memo. 2022-72

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

   The court reasoned that a gift is complete when the donor has "parted with dominion and control as to leave him no power to change its disposition." Reg. §25.2511-2(b). As long as the drawer of a check can stop payment of a check, the check is revocable under state law. A stop-payment order can be given until "the drawee bank accepts, certifies, or makes final payment of the check." That did not happen until after the date of death for any of the ten checks. The court would have included all ten checks in the estate, but because of the IRS's concession in its brief, held that the three checks that were deposited (though not yet paid) before decedent's death were excluded from the estate. *Estate of DeMuth v. Commissioner*, T.C. Memo. 2022-72 (Filed July 12, 2022, Corrected opinion served Aug. 1, 2022, Judge Jones). The estate filed a Notice of Appeal to the Third Circuit on October 25, 2022.

b. **Planning Considerations.**

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

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

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

   (3) **End-of-Life Gifts.** The relation back doctrine has not been extended to end-of-life gifts by check if the check is not paid before the decedent's death. *E.g.*, *Estate of Newman v. Commissioner*,

111 T.C. 81 (1998), *aff'd per curiam*, 203 F.3d 53 (D.C. Cir. 1999) (distinguishing *Metzger* where the donor was not still alive when the checks were accepted and paid by the drawee bank); *Rosano v. U.S.*, 67 F. Supp.2d 113 (E.D. N.Y. 1999), *aff'd*, 245 F.3d 212 (2d Cir. 2001). Revenue Ruling 96-56 expressly conditions application of the relation back doctrine on the donor still being alive when the check is paid by the drawee bank.

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

27. Pending Cases Regarding Valuation of Cryptocurrency and Life Insurance

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

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

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

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

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

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

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

28. IRS Reversal of Position Regarding Sprinkling CRUTs, CCA 202233014

a. **Prior Rulings.** The IRS has previously allowed estate and gift tax marital deductions for transfers to a charitable remainder unitrust (CRUT) where some portion of the unitrust amount was payable to a spouse (§664(d)(2) requires that at least a 5 percent unitrust amount be paid at least annually "to one or more persons (at least one of which is not an organization described in section 170(c)),"so more than a de minimis amount had to be paid annually to someone other than a charity in order for trust to be a valid CRUT), and the remaining portion of the unitrust amount could be distributed each year between a charity and the spouse at the trustee's discretion. PLRs 201845014, 201117005, 200832017, and 200813006. (PLR 201845014 differed from the prior rulings regarding the gift tax treatment of the transfer. In PLR 201845014, the donor reserved the right to change charitable beneficiaries until actual distribution and reserved a testamentary power to revoke the spouse's unitrust interest, thus causing any gifts to charity to be incomplete until actual distribution and cause any gift to spouse to be incomplete until the donor's death.) Those prior rulings pointed to the legislative history for §2056(b)(8), which provides that if the surviving spouse of a decedent is the only noncharitable beneficiary of a CRT, the terminable interest rule of §2056(b)(1) shall not apply to any interest that passes from the decedent to the surviving spouse. In the legislative history to the Economic Recovery Tax Act of 1981, the House Ways and Means Committee stated:

> If an individual transfers property outright to charity, no transfer taxes generally are imposed. Similarly, under the unlimited marital deduction provided in the committee bill, no tax generally will be imposed on an outright gift to the decedent's spouse. As a result, the committee finds no justification for imposing transfer taxes on a transfer split between a spouse and a qualifying charity. Accordingly, the bill provides a special rule for transfers of interests in the same property to a spouse and a qualifying charity.
>
> Under the bill, if an individual creates a qualified charitable remainder annuity trust or a qualified charitable remainder unitrust, and the only noncharitable beneficiaries are donor and his spouse, the disallowance rule for terminable interests does not apply. Therefore, the individual will receive a charitable deduction (under sec. 2055 or 2522) for the amount of the remainder interest and a marital deduction (under sec. 2056 or 2523) for the value of the annuity or unitrust interest; no transfer tax will be imposed. H.R. Rep. No. 97-201, at 162 (1981).

Even though the portion of the unitrust that would be paid to the spouse is uncertain, because some of the unitrust amount could be distributed either to the spouse or a charity in the trustee's discretion, an estate tax marital deduction for the full amount of the unitrust was allowed "[i]n light of the legislative history noted above." Here is the reasoning in these PLRs:

> In light of the legislative history noted above and based on the facts provided and representations made, we conclude that where Taxpayer establishes a testamentary charitable remainder unitrust for one measuring life in which the surviving spouse is the only noncharitable beneficiary, the estate tax marital deduction under § 2056(a) will completely offset the value of the assets distributed to CRUT as of Taxpayer's date of death, after deducting the value of the remainder interest qualifying for a charitable deduction under § 2055(a).

The IRS has now changed its position.

b. **CCA 202233014.** Chief Counsel Advice 202233014 (July 12, 2022; release date August 19, 2022), involved amounts passing from a decedent's estate to a CRUT providing that 25 percent of the 5 percent unitrust interest must be paid to the decedent's spouse, and the remaining 75 percent could be paid either to a designated charity or to the spouse in the trustee's complete discretion. The CCA reasons that no estate tax charitable deduction is allowed for any portion of the unitrust amount that might be distributed to the charity in the trustee's discretion "because Charity's interest is not in the form of a fixed unitrust amount to be distributed annually and no part of the unitrust interest is ascertainable or severable from Spouse's noncharitable interest. See § 2055(e)(2)(B) and § 20.2055-2(a)." Similarly, no estate tax marital deduction was allowed for that portion of the unitrust amount that could be distributed either to the spouse or charity:

> ... the extent of Spouse's interest in the remaining 75 percent portion of the unitrust amount cannot be established as of Decedent's date of death and, therefore, is not considered to pass from Decedent to Spouse as beneficial owner for purposes of § 2056(a). The extent of Spouse's interest cannot be established because the amount to be distributed to Spouse annually is within the sole and complete discretion of the trustee. It is not possible to ascertain as of the date of death whether spouse will receive any of the 75 percent portion of the unitrust amount each year since all of such portion of the unitrust interest may be distributed to charity. Because the interest is not treated as passing to Spouse for purposes of § 2056(a), Decedent's estate may not claim an

estate tax marital deduction for the value of this interest under § 2056(a). *See* § 20.2056(c)-2(a). *See also Estate of Turner v. Commissioner*, 138 T.C. 306, 316 (2012) ("property that passed to a person other than a surviving spouse cannot also be considered as passing to the surviving spouse").

Because the amount passing to charity is not ascertainable no charitable deduction is allowed, and because the amount passing to the spouse is not ascertainable no marital deduction is allowed. Simple as that according to the CCA.

The CCA makes clear in a footnote that it is changing its position from the prior rulings.

[1] The analysis and conclusion would be the same under § 2523 for a completed gift transfer to a CRUT with similar terms. In PLR 200813006, PLR 200832017, PLR 201117005, and PLR 201845014, this office ruled that taxpayers were entitled to an estate tax marital deduction under § 2056 or a gift tax marital deduction under § 2523 for a unitrust interest in a CRUT that can be distributed between charity and spouse at the trustee's discretion. The position in these earlier rulings no longer reflects the position of this office.

Before the issuance of CCA 202233014, this issue was added to the IRS's 2022 no-ruling list of matters for which no rulings would be issued until the Service resolves the issue "through publication of a revenue ruling, a revenue procedure, regulations, **or otherwise**." Sections 5.01(16) and 5.01(20) of Rev. Proc. 2022-3, 2022-1 I.R.B. 144, added whether estate or gift tax marital deductions would be allowed for sprinkling charitable remainder trusts. The 2023 no ruling list initially did not change that. But Rev. Proc. 2023-3 was re-issued on January 3, 2023, and one of the changes was to delete those items. Apparently, the IRS has determined that the issue has now been resolved, so CCA 202233014 may be the only IRS publication that we see about this topic.

For an excellent discussion of CCA 202233014, see Lawrence Katzenstein, *The IRS Has Buyer's Remorse About Earlier Ruling on Sprinkling Charitable Remainder Trust: CCA 202233014 Revisits PLR 201845014*, 47 TAX MGMT. ESTS., GIFTS & TRTS. J. NO. 6 (Nov. 10, 2022).

29. Application of Anticipatory Assignment of Income Doctrine and Availability of Charitable Deduction; Recent Cases Involving Gift to Charity Followed Quickly by Sale, *Hoensheid v. Commissioner, Keefer v. U.S., Dickinson v. Commissioner*

a. **Overview.** Three cases in the last several years have provided insight to when the anticipatory assignment of income doctrine will apply when a gift of shares is made to charity that are sold by the charity soon after the contribution. One case allowed the donor to avoid recognition of gain (*Dickinson*) but the other two, *Keefer* and *Hoensheid*, held that the anticipatory assignment of income doctrine applied to cause the donor to recognize the gain on the sale of shares. The latter two cases also denied an income tax charitable deduction (because of the charity's failure to provide an appropriate contemporaneous written acknowledgement or the donor's failure to attach a qualified appraisal to the income tax return claiming the deduction). These cases will be addressed in reverse chronological order.

b. **Assignment of Income Applied and Charitable Deduction Denied, *Estate of Hoensheid v. Commissioner*, T.C. Memo. 2023-34.**

(1) **Synopsis.** Donor and his two brothers each owned-one-third of the shares of a Company, and they all decided to sell their shares when one brother wanted to retire. Donor expressed a desire to contribute some of his shares to a Fidelity donor advised fund (the DAF) "to avoid some capital gains," but wanted to "wait as long as possible to pull the trigger" because he did not want to own fewer shares than his brothers if the sale did not go through. His attorney warned about waiting too late to make the charitable gift, advising that "the transfer would have to take place before there is a definitive agreement in place." Donor later told his attorney "I do not want to transfer the stock until we are 99% sure we are closing." On June 11, 2015, the shareholders unanimously approved the sale of all of the shares to Purchaser and consented to Donor's donation of part of his shares to the DAF (but the number of shares to pass to the DAF was left blank). Various subsequent communications and documents from Donor continued not to specify the number of shares that would be donated to the DAF until a PDF stock certificate was emailed to the DAF on July 13, 2015. The final stock purchase agreement was signed by all the parties and the sale was closed two days later on July 15, 2015 in a "simultaneous close" transaction.

(a) **Date of Charitable Gift.** The court determined that the delivery of the gift to the DAF did not occur until July 13, 2015 when the PDF stock certificate was sent to the DAF. Fidelity sent a "corrected confirmation letter" and year end account statement stating that the shares were transferred (and presumably accepted) on June 11, 2015, but the court did not view that as credible and found that acceptance of the shares did not occur until July 13.

(b) **Anticipatory Assignment of Income Applied.** The court made clear that the test for whether the donor was treated as having sold the assets and as having recognized the gain before the charitable gift occurred is not whether the transfer occurred before the definitive purchase agreement was signed. Instead, the test is whether the transfer was made before Donors had an "already fixed or vested right to the unpaid income" looking to the realities and substance of the underlying transaction rather than to formalities or hypothetical possibilities.

The court looked to several specific factors in determining whether the sale of shares was "virtually certain to occur" at the time of the charitable gift: (1) any legal obligation to sell by the charitable donee; (2) actions already taken by the parties to effect the transaction; (3) any remaining unresolved transactional contingencies; and (4) the status of corporate formalities required to finalize the transaction.

After examining those factors, the court concluded that "a donor must bear at least some risk at the time of contribution that the sale will not close." The court echoed prior decisions in not specifying a "bright line," test, but reasoned that the analysis of the four factors indicated that the delayed contribution in this case "eliminated any such risk and made the sale a virtual certainty." The anticipatory assignment of income doctrine applied to cause Donors to be taxed on the gain attributable to the eventual sale of the donated shares.

(c) **Charitable Deduction Denied.** A charitable deduction for the gift of shares to the DAF was not allowed because the qualified appraisal requirement was not satisfied. The IRS listed a number of defects in the appraisal, and the court determined that neither the doctrine of substantial compliance nor the statutory reasonable cause defense were sufficient under the facts of the case to excuse the defects. A primary factor was the failure to use a qualified appraiser and the treatment of June 11, 2015 as the transfer date. The appraisal was prepared for no additional charge by a representative of the investment banking firm used to structure the sale transfer. That representative did not hold himself out as an appraiser, had no certifications from a professional appraisal organization, and testified that he conducted valuations "briefly" and "on a limited basis."

(d) **Understatement Penalty.** The §6662(a) 20 percent understatement penalty for negligence or substantial understatement of income did not apply because Donor's attorney was a competent professional with sufficient expertise to justify reliance, and Donors adhered to her advice that "execution of the definitive purchase agreement" was the firm deadline for avoiding capital gains. While the attorney's substantive tax advice was incorrect, it was reasonable for Donors to rely on it.

Estate of Hoensheid v. Commissioner, T.C. Memo. 2023-34 (Judge Nega).

(2) **Basic Facts.** Mr. Hoensheid (Donor) and his two brothers each owned one-third of CSTC (Company) that manufactured heat-treating metal fasteners for use in autos and other commercial vehicles. After one brother announced his intention to retire, the three brothers in the fall of 2014 decided to explore selling the Company. They concluded with their investment banking firm (Firm) that $80 million was a fair target price. In early 2015 the Firm began soliciting bids, and the ultimate purchaser (Purchaser) submitted a bid for $92 million on April 2, 2015.

Mr. Hoensheid and his wife (collectively referred to as Donors) wanted to give some of his stock to a Fidelity donor advised fund (DAF) and began discussing the donation with Fidelity in mid-April 2015. A longtime tax and estate planning attorney at Donor's law firm advised him that to avoid recognizing capital gains on the donated shares "the transfer would have to take place before there is a definitive agreement in place." [Observation: The court ultimately determined that is not the correct test.]

Donor emailed his attorney that he and his wife wanted

> to put 3.5MM in the fund, but I would rather wait as long as possible to pull the trigger. If we do it and the sale does not go through, I guess my brothers could own more stock than I and I am not sure if it can be reversed. I have not definitively given [his wealth advisor] a number. Please know this and help up plan accordingly.

The following is a brief summary of a timeline of activities leading up to the donation and sale.

- April 23, 2015 – Nonbinding letter of intent signed to sell the Company for $107 million.
- May 21, 2015 – Donor's attorney emailed him that a draft purchase and sale agreement had been drafted.
- May 22, 2015 – Donor signed an affidavit representing that the buyer had a "good faith intention of completing the transaction."
- June 1, 2015 – Donor signed a Letter of Understanding with the DAF describing the planned donation but not specifying the number of shares that would be donated.
- June 1, 2015 – Donor asked his attorney to prepare a shareholder consent agreement allowing him to give shares to the DAF but stated "I do not want to transfer the stock until we are 99% sure we are closing."
- June 11, 2015 – The shareholders unanimously approved the sale of all of their shares to Purchaser and consented to Donor's donation of part of his shares to the DAF (but the number of shares to pass to the DAF was left blank). Immediately after the shareholder meeting, the board of directors approved the transfer of some of Donor's shares to the DAF and agreed to distribute all balances in an Incentive Compensation plan prior to a recapitalization of the Company (which would occur as part of the sale process).
- June 12, 2015 – Sometime after the 6-11-15 board meeting, a stock certificate was prepared to transfer shares to the DAF, but Donor kept it on his desk until July 9 or 10 when he delivered it to his attorney.
- June 12, 2015 – Purchaser's investment committee and managing partners unanimously approved the acquisition subject to completion of their financial and business due diligence.
- June 15, 2015 – Donor emailed the signed shareholder agreement to his attorney and the number of shares to pass to the DAF was still left blank.
- July 1, 2015 – Purchaser's counsel prepared a revised draft of the stock purchase agreement that still left blank the number of shares being transferred to the DAF and prepared a minority stock purchase agreement with the DAF to purchase all of the shares transferred to the DAF.
- July 6, 2015 – Purchaser organized a new corporation to purchase the shares.
- July 6, 2015 – Donor emailed the attorney, stating "We are not totally sure of the shares being transferred to the charitable fund yet" but they would know more on Wednesday or Thursday of that week.
- July 7, 2015 – Donor emailed his wealth advisor that the Company would sweep the cash from the Company prior to closing and distribute it to the brothers and Donor executed a document specifying that the impending sale would trigger bonus payments to key employees.
- July 9, 2015 – The Company prepared a revised purchase agreement with a recital that on July __, 2015 Donor "transferred 1,380 shares of Common Stock to" the DAF.

- July 10, 2015 – Purchaser prepared a revised draft of the stock purchase agreement that still left blank the date of transfer of shares to the DAF and proposed resolving an outstanding negotiating issue about an environment liability.
- July 10, 2015 – Three significant actions occurred. (1) About $6.1 million of employee bonuses were paid. (2) The Company's Article of Incorporation were amended as requested by Purchaser. (3) The attorney forwarded an updated draft of the minority stock purchase agreement to be signed by Fidelity for the DAF.
- July 13, 2015 – A revised stock purchase agreement was prepared that still left blank the date of the transfer of shares to the DAF. Later that morning, an advisor requested Fidelity to sign the minority stock purchase agreement, but Fidelity responded that it must receive the stock certificate before it could sign that agreement. About 30 minutes later a PDF stock certificate was emailed to Fidelity. It was undated but stated that 1,380.40 shares were owned by the DAF. Later that day, the Company confirmed that 1,380 shares had been transferred to the DAF and Fidelity signed the minority stock purchase agreement agreeing to sell those shares to Purchaser.
- July 14, 2015 – Attorneys for the Company forwarded a revised draft of the stock purchase agreement stating that the contribution to the DAF was made on July 10, 2015. The Company made a dividend distribution of the remaining cash in the Company, about $4.8 million, to the brothers (none to the DAF).
- July 15, 2015 – The Purchaser, Company, and the three brothers signed the final stock purchase agreement (with the provision stating that 1,380 shares had been transferred to the DAF on July 10, 2015), and a representative of Fidelity signed a document assigning 1,380 shares to Purchaser in return for about $2.94 million.
- November 18, 2015 – Fidelity sent Donor and his wife an amended contribution confirmation letter acknowledging a contribution of 1,380.400 shares on June 11, 2015, stating that Fidelity had exclusive control over the shares and that it provided no goods or services in exchange for the contribution.

Donors received a quote from a national accounting firm to appraise the donated shares but decided to use an appraisal that would be prepared for no additional charge by a representative of the Firm. The representative, who had performed limited valuations but no prior appraisals substantiating a charitable contribution of shares of a closely held corporation, prepared an appraisal of the donated shares as of June 11, 2015, providing three different values, one of which was the actual amount received by Fidelity (about $2.94 million) and several others taking into consideration additional payments made to the brothers (but not the DAF). The highest value (about $3.28 million) was reported as the value on Donors' income tax return to support the charitable deduction.

A notice of deficiency disallowed the claimed charitable deduction and applied a penalty under §6662(a). Donor filed a petition with the Tax Court contesting the disallowance of the charitable deduction and penalty. The IRS's amended answer in the Tax Court proceeding for the first time asserted that Donor made an anticipatory assignment of income and should have reported the income with respect to the sale of the 1,380 shares that had been transferred to the DAF and applied the §6662(a) penalty attributable to the anticipatory assignment of income rather than the disallowed charitable deduction.

(3) **Issues.**

(1) Whether and when Donors made a contribution of shares to the DAF.

(2) Whether Donors had unreported capital gain income "due to their right to proceeds from the sale of those shares becoming fixed before the gift."

(3) Whether Donors are entitled to a charitable contribution deduction.

(4) Whether Donors are liable for an accuracy-related penalty under §6662(a).

(4) **Whether and When Donor Made a Contribution to DAF.**

(a) **Intent.** A valid gift under Michigan law requires (1) donor intent to make a gift, (2) actual or constructive delivery, and (3) donee acceptance.

Various communications and documents beginning mid-April, 2015 evidenced an intent by Donor to make a gift of shares to the DAF, including a unanimous shareholder approval on June 11 to sell all of the Company shares and consenting to a charitable contribution of some unspecified number of shares to the DAF. However, a present intent to make a gift did not occur until July 9, 2015 when Donor settled on a number of 1,380 shares.

(b) **Delivery.** No specific action occurred on June 11 placing shares within the DAF's dominion and control. Indeed, Donor kept the stock certificate for transferring shares to the DAF in his office until July 9 or 10, at which point he delivered it to his attorney. An email of a PDF stock certificate to Fidelity on July 13 provided "the strongest documentary evidence of the shares' leaving [Donor's] dominion and control," evidencing "an open and visible change of possession."

(c) **Acceptance.** Fidelity sent an amended contribution confirmation letter acknowledging a contribution of 1,380.400 shares and a year-end account statement stating that the shares were transferred (and presumptively accepted) on June 11. However, Donor did not produce the original contribution confirmation letter dated July 15 that could have confirmed whether Fidelity consistently understood the date of the contribution to be June 11 and what errors were present in the original letter. An email from Fidelity on July 13 stating it would have to receive the stock certificate before it could take action to sell the shares to Purchaser was the more convincing evidence. **Acceptance occurred on July 13, 2015.**

(5) **Anticipatory Assignment of Income.** The court looked to its two-part test from more than 50 years earlier in *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964). In that case the court respected "the form of this kind of transaction [i.e., as a donation of shares followed by the charity's redemption of the shares rather than as a sale of shares by the taxpayer followed by a donation of the cash proceeds] if the donor (1) gives the property away absolutely and parts with title thereto (2) before the property gives rise to income by way of a sale."

The determination that the charitable gift was made on July 13, 2015, satisfied the first prong, leaving the issue of whether the gift occurred early enough to satisfy the second prong.

The test applied by the court for that "early enough" issue is whether the "donor [had] an already fixed or vested right to the unpaid income." The court looked at several factors in determining whether the "fixed or vested" right to income had occurred before the charitable gift.

(1) The DAF did not have a legal obligation to sell the shares. (While Rev. Rul. 78-197 viewed the donee's obligation to sell the donated assets as supporting an anticipatory assignment of income finding, the court did not view that as the only factor to be considered.)

(2) Numerous actions already taken by the parties suggest the sale was a virtual certainty. These include the creation of a new holding company by Purchaser to purchase the shares, amendment of the Company's Articles of Incorporation as requested by Purchaser, and various "cash sweeping" transactions that emptied the Company of its working capital (the court viewed the cash sweeping transactions as "strongly" suggesting the sale to Purchaser was a "virtual certainty" before the charitable gift on July 13).

(3) Any unresolved sale contingencies that still existed on July 13 were not "substantial enough to have posed even a small risk of the overall transaction's failing to close."

(4) Corporate formalities required to finalize the transaction were sufficiently completed for this to be a neutral factor. While the Company and shareholders did not sign the final purchase agreement until two days after the charitable gift, "final written consent was a foregone conclusion." The selling shareholders were receiving a substantial premium over their initial target price. All three brothers, and especially Donor, were involved in negotiating the

transaction, making their approval "all but assured" as of July 13. The court found that "formal shareholder approval was purely ministerial, as any decision by the brothers not to approve the sale, was as of July 13, 'remote and hypothetical.'"

The court also observed that the reasoning in *Dickinson v. Commissioner*, T.C. Memo. 2020-128 did not require a different result. That court summarized that the assignment of income doctrine applies only if (1) the redemption was practically certain to occur at the time of the gift, and (2) would have occurred whether the shareholder made the gift or not. In *Dickinson*, the redemption occurred only because the charitable gift was made (because of Fidelity's established practice of immediately selling closely-held shares after receiving them) and the shares would not have been redeemed otherwise. In *Hoensheid*, on the other hand, the shares would have been sold to Purchaser even if the shares had not been given to the DAF before the sale closing.

The court's conclusion is an excellent summary of the anticipatory assignment of income analysis regarding charitable gifts.

> To avoid an anticipatory assignment of income on the contribution of appreciated shares of stock followed by a sale by the donee, a donor **must bear at least some risk at the time of contribution that the sale will not close**. On the record before us, viewed in the light of the realities and substance of the transaction, we are convinced that petitioners' delay in transferring the CSTC shares until two days before closing **eliminated any such risk and made the sale a virtual certainty**. Petitioners' right to income from the sale of CSTC shares was thus fixed as of the gift on July 13, 2015. We hold that petitioners recognized gain on the sale of the 1,380 appreciated shares of CSTC stock.
>
> We echo prior decisions in recognizing that our holding **does not specify a bright line** for donors to stop short of in structuring charitable contributions of appreciated stock before a sale. See *Allen*, 66 T.C. at 346 (rejecting proposed bright-line rule approach and noting that "drawing lines is part of the daily grist of judicial life"); see also *Harrison v. Schaffner*, 312 U.S. 579, 583–84 (1941). However, as petitioners' tax counsel seems to have recognized in her advice to petitioner, "any tax lawyer worth [her] fees would not have recommended that a donor make a gift of appreciated stock" so close to the closing of a sale. *Ferguson v. Commissioner*, 174 F.3d at 1006; see *Allen*, 66 T.C. at 346 (recognizing that realities and substance approach puts "a premium on consulting one's lawyer early enough in the game"). By July 13, 2015, the transaction with HCI **had simply "proceeded too far down the road to enable petitioners to escape taxation on the gain attributable to the donated shares**." Allen, 66 T.C. at 348.

T.C. Memo. 2023-34 (emphasis added).

(6) **Charitable Deduction Contribution.**

Section 170(f)(8)(A) lists two requirements for receiving a charitable deduction in this situation: (1) a contemporaneous written acknowledgement of the donation by the charitable organization; and (2) a qualified appraisal.

The contemporaneous written acknowledgement requirement was satisfied. The acknowledgement must be received before the relevant tax return was required or, if earlier, the due date of the return. For a gift to a donor advised fund, the written acknowledgement must state that the donee "has exclusive legal control over the assets contributed." The acknowledgement met the requirements, but the IRS argued that the acknowledgement said the charity received "shares" rather than cash, and for income tax purposes Donors were treated as effectively recognizing the income before the transfer. The court disagreed with the IRS's "bootstrap" argument, noting that the acknowledgement correctly identified shares that were actually transferred to the DAF and that the acknowledgement does not have to describe correctly how the interest is classified for federal tax purposes.

The qualified appraisal requirement was not satisfied. The IRS listed a number of deficiencies in the appraisal (illustrating how strictly the IRS applies those requirements).

> Respondent contends that petitioners' appraisal is not a qualified appraisal because it (1) did not include the statement that it was prepared for federal income tax purposes; (2) included the incorrect date of June 11 as the date of contribution; (3) included a premature date of appraisal; (4) did not sufficiently describe the method for the valuation; (5) was not signed by Mr. Dragon or anyone from FINNEA; (6) did not include Mr. Dragon's qualifications as an appraiser; (7) did not describe the property in sufficient detail; and (8) did not include an explanation of the specific basis for the valuation. Aside from petitioners' already rejected claim

> that the June 11 date of contribution was correct, petitioners do not meaningfully dispute that their appraisal had at least some defects.

Donors argued that "the doctrine of substantial compliance and the statutory reasonable cause defense" excused any defects.

As to substantial compliance, the court found especially important that the appraiser was not a qualified appraiser. The appraisal did not state the appraiser's qualifications, he did not hold himself out as an appraiser, he had no certifications from a professional appraisal organization, and he testified that he conducted valuations "briefly" and only "on a limited basis" (once or twice a year to solicit business for prospective clients). The discrepancy in the stated date of contribution (June 11 vs. July 13) was also significant because of various substantial distributions from the Company occurring between those dates.

The court also found that the reasonable cause exception did not apply because Donors could not show reliance on the appraisal in good faith. Donors decided to rely on a free appraisal prepared by a representative of the Firm who had limited experience rather than engage a national accounting firm on a paid basis. Also, Donor's statements in various emails and retention of the undated physical stock certificate strongly suggest Donor knew or should have known that the shares were not contributed on June 11.

Accordingly, the charitable deduction was disallowed.

(7) **Section 6662(a) Penalty.**

Section 6662(a) imposes a 20% penalty for any underpayment attributable to negligence or a substantial underpayment of income tax (meaning the greater of 10% of the tax required to be reported or $5,000). The notice of deficiency assessed the penalty because of the disallowed charitable deduction, but in an amended answer, the IRS conceded the penalty related to the charitable deduction would not apply but asserted a new §6662(a) penalty related to the anticipatory assignment of income. Because that assessment came after the notice of deficiency, the IRS bore the burden of proof that no defenses to the penalty applied.

The relevant issue was different than the reason for the finding that no reasonable cause existed for the failure to comply with the qualified appraisal requirement.

> Accordingly, respondent must show that (1) [Donor's attorney] was not a competent professional with sufficient expertise to justify reliance; (2) petitioners failed to provide her with necessary and accurate information; or (3) petitioners did not actually rely in good faith on her judgment.

The court reasoned that while Donors failed to follow their attorney's cautionary note about timing, "they did adhere to the literal thrust of her advice: that 'execution of the definitive purchase agreement' was the firm deadline to contribute the shares and avoid capital gains." While the attorney's advice about the substantive tax law was incorrect, Donors could reasonably rely on it (citing *United States v. Boyle*, 469 U.S. 241 (1985)).

The court concluded that the IRS failed to establish that Donors did not have reasonable cause for the understatement of income and refused to apply the §6662(a) 20% penalty.

(8) **Observations.**

(a) **Expanded Anticipatory Assignment of Income Analysis.** The court provides a very detailed expansive analysis of the anticipatory assignment of income issue, focusing on whether the charitable transfer was made early enough before the right to income arose (the second prong of the *Humacid* test). The court made clear that the test is not whether the transfer occurred before the definitive purchase agreement was signed. Instead, the test is whether the transfer was made before Donors had an "already fixed or vested right to the unpaid income" looking to the realities and substance of the underlying transaction rather than to formalities or hypothetical possibilities.

The court looked to several specific factors in determining whether the sale of shares was "virtually certain to occur" at the time of the charitable gift: (1) any legal obligation to sell by the charitable donee; (2) actions already taken by the parties to effect the transaction; (3) any remaining unresolved transactional contingencies; and (4) the status of corporate formalities required to finalize the transaction.

After examining those factors, the court concluded that "a donor must bear at least some risk at the time of contribution that the sale will not close." The court echoed prior decisions in not specifying a "bright line," test, but reasoned that the analysis of the four factors indicated that the delayed contribution in this case "eliminated any such risk and made the sale a virtual certainty."

(b) **First Prong of *Humacid* Test Might Also Have Been a Basis for the Anticipatory Assignment of Income Result.** Interestingly, the court did not have any extended detailed analysis of the first prong of the *Humacid* test, but the "partial interest" analysis of that first prong in *Keefer v. Commissioner* might also have been applicable. The *Keefer* court concluded that the first prong was not satisfied because Donor retained some disproportionate right to partnership assets and did not transfer all rights under a 4% limited partnership interest that was assigned to charity. Similarly, in *Hoensheid*, Donors transferred 1,380 shares to the DAF, but they apparently retained various rights to dividend payments that generally would have been attributable to those shares. The Company made various distributions characterized as dividends after the transfer of shares to the DAF, and those dividend distributions were made just to the three brother-shareholders and not to the DAF.

(c) **Inconsistent With Result of Rev. Rul. 78-197 and *Rauenhorst v. Commissioner*.** *Hoensheid* (and *Dickinson v. Commissioner* discussed in Item 29.d below) reasoned there is no "bright line" test to determine when the assignment of income doctrine applies. *Hoensheid* briefly addressed the court's prior discussion of Rev. Rul. 78-197, 1978-1 C.B. 83 (which has been viewed by the Tax Court as a "bright line" test) and *Rauenhorst v. Commissioner*, 119 T.C. 157 (1993). Despite the court's attempt to distinguish *Rauenhorst* and Rev. Rul. 78-197, the court's approach in *Hoensheid* seems very inconsistent with the result in *Rauenhorst*. First some background.

In *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd on another issue*, 523 F.2d 1308 (8th Cir. 1975), the taxpayer had voting control of a corporation and foundation. The taxpayer donated shares of stock to the foundation and the following day caused the corporation to redeem the foundation's shares. When the foundation received the stock, no vote for the redemption had been taken, and the foundation had the voting power to prevent the redemption. The Tax Court refused to apply the assignment of income doctrine (to treat the donor as having sold the stock and contributed the sale proceeds to the foundation) because the foundation was not a sham or the alter ego of the taxpayer, the transfer to the foundation was a valid gift, and the foundation was not "powerless to reverse the plans of the petitioner."

The IRS acquiesced in *Palmer* in Rev. Rul. 78-197. The ruling discussed a charitable contribution followed by a prearranged redemption. The ruling briefly summarized *Palmer* and concluded the Tax Court recognized the transfer of stock (rather than sale proceeds) to the foundation in *Palmer* because the foundation was not a sham, the transfer of stock was a valid gift, "and the foundation was not bound to go through with the redemption at the time it received title to the shares." The ruling concluded: "The Service will treat the proceeds of a redemption of stock under facts similar to those in *Palmer* as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption."

Rauenhorst involved a contribution of stock warrants to charities which seven days later agreed to sell them to a purchaser who was going to purchase all the stock of the corporation. The IRS argued that the donor's right to receive the sale proceeds from the stock sale "ripened to a practical certainty" at the time of the assignments, and the assignment of income doctrine should apply. The court summarized Rev. Rul. 78-197 as establishing a "bright-line" test:

> The Internal Revenue Service (IRS), in Rev. Rul. 78-197, 1978-1 C.B. 83, acquiesced to our decision in *Palmer v. Commissioner, supra,* and in doing so devised a "bright-line" test which focuses on the donee's control over the disposition of the appreciated property. …

119 T.C. at 165.

The court then stated that it had not adopted the bright-line test of Rev. Rul. 78-197.

> [W]e have indicated our reluctance to elevate the question of donee control to a talisman for resolving anticipatory assignment of income issues. For example, in *Allen v. Commissioner,* 66 T.C. 340, 347-348 (1976), we stated that the donee's power to reverse the donor's anticipated course of disposition was "only one factor to be considered in ascertaining the `realities and substance' of the transaction." Cf. *Jones v. United States,* 531 F.2d 1343, 1346 (6th Cir. 1976). In a more recent opinion, we further extrapolated our position as follows:
>
>> In determining the reality and substance of a transfer, the ability, or the lack thereof, of the transferee to alter a prearranged course of disposition with respect to the transferred property provides cogent evidence of whether there existed a fixed right to income at the time of transfer. Although control over the disposition of the transferred property is significant to the assignment of income analysis, the ultimate question is whether the transferor, considering the reality and substance of all the circumstances, had a fixed right to income in the property at the time of transfer. [*Ferguson v. Commissioner,* 108 T.C. at 259; citations omitted.]
>
> This Court has not adopted the "bright-line" test stated in Rev. Rul. 78-197, *supra,* as the test for resolving anticipatory assignment of income issues, and instead we have considered the donee's control to be merely a factor, albeit an important factor.

119 T.C. at 166.

The IRS argued that the appropriate test was whether the sale was a "practical certainty" before the contribution, which the court viewed as an abandonment by the IRS of its "legally obligated" test from Rev. Rul. 73-197: "When respondent's arguments are boiled down to their essential elements, he argues against the validity of the bright-line test of Rev. Rul. 78-197 …."

The court stated, in very forceful terms, though, that the IRS was bound to follow its own revenue rulings.

> Respondent's counsel may not choose to litigate against the officially published rulings of the Commissioner without first withdrawing or modifying those rulings. The result of contrary action is capricious application of the law. [Quoting *Phillips v. Commissioner,* 88 T.C. at 534.]

119 T.C. at 172.

Thus, although the *Rauenhorst* court stated that it did not adopt the bright-line test in Rev. Rul. 78-197, because it viewed the IRS's position as contrary to its own revenue ruling, the court proceeded to decide the case based on "whether the charitable donees were legally obligated or could be compelled to sell the stock warrants at the time of the assignments." The Tax Court reasoned that Rev. Rul. 78-197 had been in existence nearly 25 years without being revoked or modified and the taxpayers relied on that ruling in planning their charitable contributions. The IRS pointed to various facts suggesting that the right to the sale proceeds had "ripened to a practical certainty" before the transfer to the charity, but the court viewed that as unimportant:

> Those items might be particularly relevant for determining whether the stock warrant purchase ripened to a practical certainty; however, none of those items alone, or in combination, show that the donees were legally bound, or could be compelled, to sell their stock warrants.

That reasoning would suggest that in Tax Court litigation the court should apply the legally obligated "bright-line" test in any case in which the IRS argues that a "practical certainty" test or any test other than the legally obligated test should govern to determine whether there is an assignment of income if assets contributed to charity are sold soon after by the charity.

Although the "virtually certain to occur" approach in *Hoensheid* is consistent with the Court's *statement* in *Rauenhorst* that it does not adopt the legal obligated test as the proper approach, the approach in *Hoensheid* seems hard to reconcile with the analytical approach in and result of *Rauenhorst* (again, a full Tax Court opinion).

(d) **A Tax Court Case Basing a Holding on the Burden of Proof.** Tax Court cases very frequently discuss which party has the burden of proof as to particular issues but say that does not matter in the particular case because the court is making its decision based on a preponderance of the evidence. *Hoensheid* is an example of a case in which one of holdings (the penalty issue) apparently was based on the IRS not meeting its burden of proof (i.e., "respondent has failed to establish").

c. **Assignment of Income Applied and Charitable Deduction Denied, *Keefer v. U.S.***

(1) **Brief Facts.** Donor owned an interest in a partnership that was attempting to sell a hotel owned by the partnership.

- On April 23, 2015, the eventual purchaser sent a nonbinding letter of intent for the purchase of the hotel. The partnership did not sign the letter of intent but continued to negotiate with other potential buyers.
- On June 5, 2015, 13 days before the assignment was made to Charity, Charity sent a 12-page packet to Donor relating to the establishment of a donor advised fund (DAF). It discussed ownership, grantmaking, and management details, including that the Distribution Committee had "ultimate authority and control of all assets in the DAF" and that "[d]onor advised funds will be the exclusive property of The Pi Fund."
- Donor signed the packet on June 8, 2015, (the "June 8 Packet").
- On June 18, 2015, a buyer tentatively agreed with the partnership to purchase the hotel for $54 million, Donor assigned a 4% limited partnership interest to Charity (which had the intriguing name "Pi Foundation"), with an oral side agreement that Charity would share in the proceeds of only the hotel sale but not other partnership assets.
- On July 2, 2015, the parties signed a contract for the partnership to sell the hotel, under which the buyer had a 30-day review period.
- The hotel sale closing occurred on August 11, 2015.
- On September 9, 2015, almost three months after the donation, Charity sent a letter to Donor acknowledging the donation and stating that no goods or services were provided in exchange for the donation, but it did not state that Charity had exclusive legal control over the assets contributed.

Keefer v. U.S., 130 AFTR 2d 2022-5405 (N.D. Tex. August 10, 2022) (denying motion for reconsideration of Order denying charitable deduction for failure to meet contemporaneous written acknowledgement requirement), 130 AFTR 2d 2022-5002 (July 6, 2022).

(2) **Assignment of Income.** The IRS asserted that the assignment of income doctrine applied, and Donor had to recognize gain on its portion of the sale proceeds. The court applied the two-part test described in *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964): (1) the donor gives the property away absolutely and parts with title thereto (2) before the property gives rise to income by way of a sale.

(a) **Second Prong Satisfied.** The court held that Donor satisfied the second prong of the test. Many of these cases involve the redemption of donated stock, and the second prong generally focuses on whether the right to the income from the redemption of appreciated stock vested before the donation. Some cases have extended the doctrine to situations in which a redemption was so imminent that the right to income "had already crystallized at the time of the gift." The Ninth Circuit in *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999) applied the doctrine to a situation in which a redemption is "practically certain to proceed" without a binding obligation. Even that "practically certain to occur" *Ferguson* test is not satisfied by the facts in *Keefer*.

The letter of intent sent from the eventual buyer on April 23, 2015, was nonbinding and was never signed by the partnership. No contract of sale had been signed when the assignment was made. Even after the contract had been signed at the time of the donation, the buyer had a 30-day review period, and until that review period closed, there was "no binding obligation to close and the deal was not 'practically certain' to go through."

(b) **First Prong Not Satisfied.** The first prong of the *Humacid* test, however, was not satisfied. The court described the assignment of income doctrine, quoting from *Caruth Corp., v. United States*, 865 F.2d 644, 648 (5th Cir. 1989). "[T]he crucial question is "whether the asset itself, or merely the income from it, has been transferred." "If the taxpayer gives away the entire asset, with accrued earnings, the assignment of income doctrine does not apply." But it does apply "[i]f the taxpayer carves income or a partial interest out of the [granted] asset, and retains something for himself." *See also Salty Brine I, Ltd. v. United States*, 761 F.3d 484, 491 (5th Cir. 2014).

The court concluded that the first prong was not satisfied because Donor assigned only the right to his portion of the Hotel sale proceeds and not all rights under its 4% limited partnership interest. Prior to the assignment to Charity, the partnership had accrued money that was owed to pre-existing partners for pre-donation earnings that the partnership could not distribute because it was required to maintain a certain amount of cash reserves to comply with loan and franchise obligations for the hotel (to be able to make renovations required under the franchise agreement if the sale did not go through). Donor argued that the "payment of pre-existing liability to its pre-existing partners is not a 'carving out' from the 4% partnership interest" but is merely like the partnership paying a pre-existing light bill. The court disagreed, reasoning that the reserves were not to pay liabilities like a pre-existing light bill but were reserves of cash held back to address future potential liabilities. The cash reserves fall within the partnership's definition of "Available Cash Flow" for distributions, and by withholding those reserves from the donated 4% limited partnership interest, Charity and Donor agreed that Charity "would only share in the proceeds from Seller's Closing Statement; [Charity] would not receive its pro rata share in other net assets of the Partnership." (Emphasis in original). Therefore, donor had to recognize income attributable to his portion of the hotel sale proceeds.

(3) **Charitable Deduction Denied; No Acknowledgement of Donation.** To receive an income tax charitable deduction for a contribution Section 170(f)(8) requires a contemporaneous written acknowledgment (CWA) containing certain items, and §170(f)(18) requires that for contributions to a donor advised fund the acknowledgment must state that the DAF has exclusive legal control over the assets contributed. The June 8 Packet (signed ten days before the assignment to Charity)) did not qualify because a pre-donation document cannot serve as a CWA. An "acknowledgement" "memorializes a gift that has been completed or is legally obligated to occur, not one that is merely contemplated or uncertain to occur." Also, it did not supplement the written acknowledgement that was subsequently sent almost three months later for various reasons, including that neither document references the other and the CWA requirement requires strict (not merely substantial) compliance.

Critically, each of the cases cited above gives the Court *permission* to construe multiple documents together, where appropriate under all the circumstances and to give effect to the intent of the parties. None of these cases *require*s the Court to do so. And here, considering the ten-day gap between the June 8, 2015 DAF Packet's signing and the June 18, 2015 Assignment of Interest's execution; that only one (Kevin) out of three signatories to the June 18, 2015 Assignment of Interest signed the June 8, 2015 DAF Packet; that neither document references the other; and that the CWA requirement requires strict (not substantial) compliance, the Court finds that the realities of the situation do not permit the documents to be read together. *See* Doc. 66, DAF Packet, 38; Doc. 69-5, Assignment Int., 443–44; *see also Keefer*, 2022 WL 2473369 at *16–17 (discussing cases permitting a court to consider multiple documents as forming a CWA and the strict compliance requirement). 130 AFTR 2d 2022-5406 at 2022-5408.

(4) **Harsh Result.** Donor had to recognize income on the sale of the hotel attributable to the donated interest (4% of a $54 million sale – which could be a sizeable amount of income, depending on the partnership's basis in the hotel) AND failed to receive an income tax charitable deduction for his very substantial donation because of failure to follow a formality requirement. (Presumably, Charity will change its acceptance procedures and acknowledgement letter after seeing the horrendous results of this case.) For a discussion of Keefer, see Richard Fox & Jonathan Blattmachr, *Keefer v. US Provides Harsh Reminder to Donors of Potential Application of Assignment of Income Doctrine and Requirement to Obtain Proper Contemporaneous Written Acknowledgement*, LEIMBERG CHARITABLE PLANNING NEWSLETTER #319 (September 20, 2022).

d. **No Assignment of Income, *Dickinson v. Commissioner*.**

(1) **Basic Facts.** A shareholder and chief financial officer of a privately held company desired to donate shares of stock to the Fidelity Investments Charitable Gift Fund (Gift Fund). In 2013, 2014, and 2015, the board of directors authorized donations of shares to the Fidelity Gift Fund because it had a written policy requiring that it immediately liquidate donated shares and would promptly tender the donated stock to the issuer for cash. In each of those years, the taxpayer donated appreciated shares to the Gift Fund. Separate documents were signed by the taxpayer, by the corporation, and by the Gift Fund making clear that the Gift Fund owned and had exclusive control of the shares prior to the redemption and had full discretion over all conditions of subsequent sale and was not under any obligation to sell the shares. The Gift Fund redeemed the shares shortly after each donation, and the IRS ultimately claimed that the redemptions resulted in an assignment of income, as if the shareholder first sold the shares (realizing gain) and then contributed the cash to the Gift Fund. *Dickinson v. Commissioner*, T.C. Memo. 2020-128 (Sept. 3, 2020) (Judge Greaves, summary judgment).

(2) ***Humacid v Commissioner* Analysis.** The two-pronged test of *Humacid Co. v. Commissioner* avoids an assignment of income if "the donor (1) gives the property away absolutely and parts with title thereto (2) before the property gives rise to income by way of a sale."

The donor met the first prong because it transferred all rights in the donated property (as confirmed by the various documents signed by the taxpayer, the corporation and the Gift Fund). Even a **preexisting understanding** that the charity "would redeem donated stock does not convert a postdonation redemption into a predonation redemption" or suggest "that the donor failed to transfer all his right in the donated stock."

The second prong, that the donation was made before the "property gives rise to income," "ensures that if stock is about to be acquired by the issuing corporation via redemption, the shareholder cannot avoid tax on the transaction by donating the stock before he receives the proceeds."

(3) ***Dickinson* Test.** The court summarized its test in this type of situation as follows: The assignment of income doctrine applies "only if"

(1) "the redemption was practically certain to occur at the time of the gift, and"

(2) "would have occurred whether the shareholder made the gift or not."

The first leg was probably satisfied on these facts, in light of Fidelity's strict written policy that it would immediately sell such donated stock. But the second leg was not satisfied. The taxpayer set out on three occasions to make charitable gifts. There was no indication whatsoever that the taxpayer would have sold shares to the corporation if the shares had not been donated to the Gift Fund.

(4) **Refusal to Apply "Legally Bound" Test of Rev. Rul. 78-197.** The IRS announced in Rev. Rul. 78-197, 1978-1 C.B. 83, that it refuses to treat a redemption in this type of situation as an anticipatory assignment of income as long as the charity is not legally bound to sell the donated shares and cannot be compelled to surrender the shares for redemption. The IRS argued in *Dickinson* that taxpayer's and corporation's reliance on the Fidelity policy of immediately offering donated shares for redemption, "may suggest the donor had a fixed right to redemption income

at the time of the donation." The court disagreed, reasoning that it refused to adopt Rev. Rul. 78-197 as the test for resolving anticipatory assignment of income claims in *Rauenhorst v. Commissioner*, 119 T.C. 157 (2002), and does not do so in this case either.

(5) **Further Discussion.** For a more detailed summary of *Dickinson v. Commissioner* and its analysis of the assignment of income doctrine, see Item 30 of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

30. Sale Decisions by Sponsors of Donor Advised Funds Contrary to Expectations of Donors, *Pinkert v. Schwab Charitable Fund*

a. **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* (discussed in Item 30.b below). 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.

   The Ninth Circuit Court of Appeals affirmed the district court's finding that the donor lacked standing. The donor asserted that Schwab's conduct injured him in four ways: (1) it impaired his retained property right to direct the funds to charities, (2) his reputation will not be enhanced as much as he intended, (3) the level of expression of his values is diminished, and (4) he may need to contribute more to the Fund to make up for the mismanagement. The court reasoned that the donor had not retained a property right because he could only give non-binding recommendations and he did not allege that Schwab refused to listen to his advice; "he does not allege that the right that he *does* have—the right to provide nonbinding advice—was infringed." As to the last three alleged injuries, the court reasoned that that it did not need to decide whether those injuries were cognizable because donor did not allege that he had experienced or will imminently experience those purported injuries. *Pinkert v. Schwab Charitable Fund*, No. 3:20-cv-07657 (N.D. Calif. Order dated June 17, 2021), *aff'd*, 130 AFTR 2d 2022-5986 (9th Cir. September 14, 2022).

b. ***Fairbairn v. Fidelity Investment Charitable Fund*.** A similar case that also held the DAF was not liable for selling all the stock contributed to the DAF the day following the transfer is Fairbairn, et al. v. Fidelity Investments Charitable Gift Fund, No. 3:18-cv-04881-JSC (N.D. Calif, Feb 26, 2021). For a summary of *Fairbairn*, see Item 14.a of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

c. **Planning Pointers.**

- 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, as happened in *Fairbairn*).
- *Pinkert* and *Fairbairn* are recent cases 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 a huge block of assets in a short time.

31. Tax Affecting for Valuing an S Corporation Recognized When Used by All Experts in the Case But Is Not Always (or Even Usually) Proper, *Estate of Cecil v. Commissioner*

a. **Synopsis.** In 2010, William Cecil, Sr. (grandson of George W. Vanderbilt who built the famed Vanderbilt Biltmore House in Asheville, North Carolina between 1889 and 1895) and his wife gave stock (and made the split gift election) in an S corporation that owned the Biltmore House and some of the surrounding land, an Inn, and other tourist facilities. (The Biltmore House remains the largest privately owned house in the United States.) Voting stock (one of seven shares of voting stock, representing 14.29% of the voting stock) was given to the donors' two children (Bill Cecil and Dini Pickering) and nonvoting stock was given to their five grandchildren. Bill Cecil's three children each received 15.57% of the nonvoting stock and Dini Pickering's two children each received 23.36% of the nonvoting stock. (The donors' two children are both very active in the company; Bill Cecil is the president and CEO and Dini Pickering is vice chairman of the board of directors and has worked for the company for over 30 years.) The corporate assets were used to generate earnings, producing about $70 million of revenue in 2010 ($38.4 million of that coming from admission tickets). The company reported assets and liabilities of about $53.6 million and $33.3 million, respectively, or a net of $20.2 million.

The donors attached an appraisal to the gift tax return (using a weighted average of value under an asset approach and an income approach) reporting a value of $3,308 per share of voting stock and $2,236 per share of nonvoting stock, for gifts by each donor of about $10.44 million. In the gift tax audit, the IRS came up with a **much** larger value of the gifts, asserting a gift tax deficiency of about $13.1 million by each donor. Both donors later died and were substituted in the gift tax case by their coexecutor Bill Cecil.

At trial, donors presented two experts (neither of which prepared the appraisal attached to the gift tax return). Both used the income and market methods of valuation, and both used tax affecting to adjust for the fact that their analyses used capitalization and discount rates based on data for C corporations (presumably publicly traded companies), whereas the S corporation's income was before-tax cashflow. The IRS used one appraiser to appraise artwork (at $13,250,000) and another to value the donated shares using an asset-based method (but weighting it at only 10%) and an income method (and also using tax affecting under the income approach analysis).

The gifts were made in November 2010, the Tax Court trial was held February 26-26, 2016 **(seven years ago!),** and the briefing was completed in July 2016. Based on the long delay, many planners (and probably the attorneys representing the taxpayers) assumed this case might result in an opinion reviewed by the full Tax Court with a detailed analysis of the court's approach to tax affecting. Not so. The opinion devoted only about two pages to its tax affecting analysis.

The court noted that beginning with the *Gross v. Commissioner* Tax Court case in 1999, the court has generally held that tax affecting is not appropriate for valuing S corporations, citing various subsequent cases that have rejected using tax affecting (*Estate of Gallagher*, *Dallas*, *Wall*, and *Estate of Giustina*) The court discussed two more recent cases, one of which (*Estate of Jones*) allowed tax affecting in part because the IRS's expert was largely silent about tax affecting other than to disagree with the way taxpayer's expert had applied it, and the other (*Estate of Jackson*) rejected a tax affecting analysis based on an assumption that buyers would be C corporations but the court was not persuaded of that. Because all the experts in the *Cecil* case (other than the art expert), including the IRS's expert, agreed that tax affecting was appropriate and one of the taxpayers' experts and the IRS expert agreed on the appropriate tax affecting analysis, the court concluded the circumstances "require our application of tax affecting." The court made very clear, however, that it was sanctioning the use of tax affecting generally with this important caveat: "We emphasize, however, that while we are applying tax affecting here, given the unique setting at hand, we are not necessarily holding that tax affecting is always, or even more often than not, a proper consideration for valuing an S corporation."

The court analyzed the reports from the various experts. The court assigned "zero weight" to the IRS expert because it used an asset-based approach even though liquidation was "most unlikely" (without commenting on the fact the appraiser assigned merely a 10% weight to its asset-based approach and without noting that it actually *did* apply parts of that expert's analysis). The court did adopt the IRS's expert's 17.6% rate for applying the tax affecting analysis. The court found flaws in both of the taxpayers' experts reports as well, but used one of the reports as "the truest value of the subject stock's prediscount fair market value" (but applying a different rate for the tax affecting analysis). The court adjusted the lack of control and marketability discounts, applying a 20% lack of control discount (used by one of the taxpayer's experts) and applying lack of marketability discounts of 19%, 22% and 27%, respectively, for the voting stock, the 15.57% blocks of nonvoting stock and the 23.36% blocks of nonvoting stock (marketability discounts used by the IRS's expert).

The court did not arrive at a final value for the gifted shares. However, the expert's report that the court accepted as the "truest value of the … prediscount fair market value" concluded that the gifted shares were worth $1,131 per share for voting stock and $1,108 for nonvoting stock. It used a 20% lack of control discount (which was accepted by the court) and a 30% lack of marketability discount (vs. the 19%, 22% and 27% lack of marketability discounts the court decided were proper). Even after adjustments are made for the differences in the lack of marketability discount and the adjustment to the rate used in the tax affecting analysis, the approximately $1,100 per share value in the report is much lower than the roughly $3,300 per share value used on the gift tax return, All of that suggests the taxpayers may be entitled to a gift tax refund. *Estate of Cecil v. Commissioner*, T.C. Memo. 2023-24 (February 28, 2023, Judge Ashford).

b. **Overview of Valuation Approaches.** The opinion provides a helpful overview of three general approaches used for valuing assets.

(1) **Market Approach.** The market approach values property by considering the sale prices of substantially similar comparable properties and making adjustments to account for differences between the subject property and the comparable properties.

(2) **Income Approach.** The income approach computes the present value of the estimated future cashflow, using an appropriate discount rate for that type of property and adds that to the present value of the residual value of the property.

(3) **Asset-Based Approach.** This approach is generally the fair market value of the net assets (assets less liabilities). (This approach is often not appropriate for ongoing businesses that will not be liquidated in the foreseeable future.)

c. **Brief Summary of Experts' Reports.**

(1) **Taxpayers' Experts.** At trial, donors presented two experts (neither of which prepared the appraisal attached to the gift tax return).

Donors' first expert, David Adams, chose a combination of the income and market methods (using two approaches under his market method). He rejected the asset-based approach because the number of donated shares was too small to force a liquidation. He took into account tax affecting and a shareholder agreement, and applied a 50% weighting to each method. After including a 30% discount for lack of marketability and a 20% discount for lack of control, he valued the voting and nonvoting shares at $1,019 per share with tax affecting and the shareholder agreement in effect.

Donors' second expert, George Hawkins, also used the income and market method, rejecting the asset-based method because the donated shares could not force a liquidation. His income approach applied a capitalization rate presumably based on data from publicly traded companies because he first valued it as if the company was a C corporation and then tax affected that preliminary value to value the S corporation's share as if the S corporation paid the same level of taxes as a C corporation. (Mr. Hawkins, as well as the IRS's expert, both used the "S Corporation Economic Adjustment Model (SEAM)" method for their tax affecting analysis.) His income method produced a value per share of $1.353.83 and his market method resulted in a value of $1,131 per share for voting stock and $1,108 per share for non-voting stock (after applying a 25% discount for lack of marketability and a 2% discount for lack of voting rights).

(2) **IRS's Experts.** The IRS used one expert to appraise art owned by the company (appraising the artwork at $13,250,000). Its other expert, Robert Morrison, valued the company using the asset-based approach and income method. For his asset-based method analysis, he adjusted the $20.2 million) net asset value reported by the company in various ways, resulting in a much larger net asset value of $146.6 million. However, he applied only a 10% weighting to the asset-based method because the company "did not seek to maximize its assets." His income method analysis used capitalization rates and discount rates based on after-tax cashflows, so he tax affected the results using the SEAM method. After weighting the two methods, he applied lack of marketability discounts of 19% for the voting stock and 22% and 27% for the smaller and larger blocks of gifted nonvoting shares, respectively, resulting in values of $4,000 per share for the voting stock and $3,066 per share for the 23.36% block and $3,276 per share for the 15.57% block of nonvoting shares.

d. **Tax Affecting.** "Tax affecting" refers to the step in the valuation of a closely-held business that seeks to adjust for certain differences between passthrough entities and C corporations. The rationale for tax affecting was described very simply in *Cecil*: "Where, as here, the data used to value an S corporation are largely based on the data from C corporations, proponents of tax affecting believe that the mismatch from pretax cashflows and after-tax discount rates must be adjusted through tax affecting to ascertain the fair market value of the S corporation." Typically, tax affecting is discussed in the context of S corporation valuations, but tax affecting can be applied in valuing other passthrough entities, i.e., partnerships. (*Estate of Jones* applied a tax affecting analysis in determining the valuation of an S corporation and a limited partnership.)

(1) **Analysis in *Cecil*.** Although the IRS's internal valuation guide had for years in discussing S corporation valuations referred to the need to adjust the net income for income taxes using corporate tax rates when using industry price to earnings ratios, the *Gross v. Commissioner* Tax Court case in 1999 concluded that tax affecting is not appropriate in that case; in fact, Judge Halpern pointed out that owners expect to save money by using S corporations and that savings should not be ignored. T.C. Memo. 1999-254, aff'd, 272 F.3d 333 (6th 2001). The *Cecil* court observed that the Tax Court has continued to reject tax affecting in valuing S corporations, citing various subsequent cases (*Estate of Gallagher*, *Dallas*, *Wall*, and *Estate of Giustina*)

The court discussed two more recent cases. *Estate of Jones* allowed tax affecting in part because the IRS's expert was largely silent about tax affecting other than to disagree with the way taxpayer's expert had applied it. However, *Estate of Jackson* rejected a tax affecting analysis based on an assumption that buyers would be C corporations. In *Jackson* the court was not persuaded that the buyers would necessarily be C corporations.

In light of that history, Judge Ashford seemed reluctant to adopt a tax affecting analysis. But the court concluded, based on the facts of that case (and that even the IRS's expert agreed that tax affecting should be applied) the circumstances of the case "require our application of tax affecting."

> Here, experts on both sides agree that tax affecting is necessary to value the subject stock. Messrs. Morrison [the IRS's expert] and Hawkins [one of the taxpayers' experts] also agree that the SEAM method is the appropriate method to employ in the setting at hand to account for tax affecting and that a factor of at least 17.6% applies here for that purpose. As we observed in *Estate of Jackson,* there is not a total bar

> against the use of tax affecting when the circumstances call for it. Now given that each side's experts (with the exception of Ms. Wolf [the IRS's art appraiser]who did not opine on this point) totally agree that tax affecting should be taken into account to value the subject stock, and experts on both sides agree on the specific method that we should employ to take that principle into account, we conclude that **the circumstances of these cases require our application of tax affecting.** While Messrs. Morrison and Hawkins do not agree on the specific rate that applies here to implement tax affecting (Mr. Hawkins determined the rate to be 24.6% while Mr. Morrison determined the rate to be 17.6%), we consider it appropriate on the basis of the record (and relying on Mr. Morrison's opinion in this regard) to set that rate at 17.6%. **We emphasize, however, that while we are applying tax affecting here, given the unique setting at hand, we are not necessarily holding that tax affecting is always, or even more often than not, a proper consideration for valuing an S corporation.** (emphasis added)

(2) **Core Justifications of Tax Affecting**. While many discussions of tax affecting are quite technical, the core justifications for tax affecting are generally (1) that a hypothetical willing buyer in the willing-buyer-willing-seller construct of fair market value is looking for a return on the investment and necessarily will enjoy and therefore evaluate that return only on an *after-tax* basis and (2) that comparable data to use in the valuation process typically comes from public sources and therefore largely comes from C corporations, for which earnings are, again, necessarily determined on an *after-tax* basis. Corollaries to those justifications are that passthrough status (3) confers a benefit of a single level of tax compared to a C corporation, but also (4) limits the universe of potential buyers and investors, who might not be able to buy or invest without forfeiting or jeopardizing (or at least complicating) the S corporation status or other passthrough status. Thus, tax affecting sometimes includes adjustments to accommodate those corollaries, or sometimes is followed by the application of, for example, an "S corporation premium" as the next step following the tax affecting. That approach is incorporated in a well-known model used by many appraisers in valuing S corporation stock, referred to sometimes as the S Corporation Economic Adjustment Model and sometimes as the S Corporation Equity Adjustment Model, or, in either case, "SEAM." (This is the tax affecting approach that was used by two of the experts (including the IRS expert) in *Cecil*.) This approach was developed by Daniel R. Van Vleet (and is sometimes referred to as the Van Vleet model), and it is an approach for valuing passthrough entities when C corporation data is used to estimate the value. It adjusts for differences in entity-level and shareholder-level taxation between C corporations, S corporations, and their shareholders. *See* Daniel Van Vleet, *A New Way to Value S Corporation Securities*, TRUSTS & ESTATES (March 2003). For a more in-depth discussion of the Van Vleet Model see William Frazier, *In Defense of Tax Affecting*, **http://www.srr.com/article/defense-tax-affecting**.

(3) **Prior Internal IRS Guidance**. Some 20 years ago, the IRS's internal valuation guide for income, estate, and gift taxes explained tax affecting (without calling it that) this way:

> [S] corporations are treated similarly to partnerships for tax purposes. S Corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only to adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.

The IRS's internal examination technique handbook for estate tax examiners added:

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

(4) **Initial Tax Court Rejection of Tax Affecting, *Gross v. Commissioner***. While tax affecting was not a new concept 20 years ago, it may have been overtly and directly raised and considered in a gift tax case for the first time in *Gross v. Commissioner*, T.C. Memo. 1999-254. In *Gross* the taxpayer's appraiser tax affected the value of stock of an S corporation, by using an assumed undiscounted corporate income tax rate of 40 percent. Judge Halpern viewed that as "a fictitious tax burden, equal to an assumed corporate tax rate of 40 percent." He tied the idea of tax affecting for an S corporation to the "*probability*" that the corporation would lose its S status and concluded that "[w]e do not … think it is reasonable to tax affect an S corporation's projected earnings with an undiscounted corporate tax rate without facts or circumstances sufficient to

establish the likelihood that the election would be lost." He acknowledged that the taxpayer's appraiser had discussed the disadvantage of S corporations in raising capital, due to the restrictions of ownership necessary to qualify for the S election, but concluded:

> This concern is more appropriately addressed in determining an appropriate cost of capital. In any event, it is not a justification for tax affecting an S corporation's projected earnings under a discounted cash-flow approach. [The taxpayer's appraiser] has failed to put forward any cognizable argument justifying the merits of tax affecting [the corporation's] projected earnings under a discounted cash-flow approach.

He also pointed out, although not in such words, that tax affecting was counter-intuitive, noting (emphasis added) that "[w]e believe that the principal *benefit* that shareholders *expect* from an S corporation election is a *reduction* in the total tax burden imposed on the enterprise."

Regarding the IRS internal guide and handbook quoted above, Judge Halpern stated:

> Both statements lack analytical support, and we refuse to interpret them as establishing respondent's advocacy of tax-affecting as a necessary adjustment to be made in applying the discounted cash-flow analysis to establish the value of an S corporation.

In a confusing set of opinions, in which the lead opinion was not "the holding of the court," the Court of Appeals for the Sixth Circuit affirmed. The judge who wrote the lead opinion stated:

> I must recognize that we are merely determining those factors that hypothetical parties to a sale of [the corporation's] stock would have considered as of the gift date. In this regard, I believe that past practices, which the IRS had not deemed to create a deficiency, are demonstrative of the idea that such hypothetical actors would have considered tax affecting [the corporation's] stock. This fact in conjunction with the testimony of the experts informs my conclusion that the court's decision to use a 0% tax affect in deriving the value of [the corporation's] stock was implausible.

A judge who wrote an opinion "concurring in part, dissenting in part," but joined by another judge, viewed the issue essentially as an issue of fact, stating:

> Valuing closely held stock incorporates a number of alternative methods of valuation, and the appellate courts have afforded the tax court broad discretion in determining what method of valuation most fairly represents the fair market value of the stock in light of the facts presented at trial. See *Palmer v. Comm'r of Internal Rev.*, 523 F.2d 1308 (8th Cir. 1975). Moreover, "complex factual inquiries such as valuation require the trial judge to evaluate a number of facts: whether an expert appraiser's experience and testimony entitle his opinion to more or less weight; whether an alleged comparable sale fairly approximates the subject property's market value; and the overall cogency of each expert's analysis." *Ebben v. Comm'r of Internal Rev.*, 783 F.2d 906, 909 (9th Cir. 1986).
>
> …
>
> Valuation is a fact specific task exercise; tax affecting is but one tool in accomplishing that task. The goal of valuation is to create a fictional sale at the time the gift was made, taking into account the facts and circumstances of the particular transaction. The Tax Court did that and determined that tax affecting was not appropriate in this case. I do not find its conclusions clearly erroneous.

(5) **IRS Response to *Gross***. The IRS jumped on the decision in *Gross*, viewed it as a Tax Court ban on tax affecting, rewrote its internal guidance, and took very strong stands against tax affecting in subsequent cases.

(6) **Subsequent Cases Went Along, *E.g., Gallagher v. Commissioner***. The Tax Court largely went along with the IRS. For example, in *Gallagher v. Commissioner*, T.C. Memo. 2011-148, Judge Halpern, again, wrote (emphasis added):

> As we stated in *Gross v. Commissioner*, … the principal **benefit** enjoyed by S corporation shareholders is the **reduction** in their total tax burden, a **benefit** that should be considered when valuing an S corporation. [The estate's expert] has advanced no reason for ignoring such a benefit, and we will not impose an unjustified **fictitious** corporate tax rate burden on [the corporation's] future earnings.

(7) **Until *Kress v. United States***. In 2019, *Kress v. United States*, 123 AFTR 2d 2019-1224 (E.D. Wis. March 26, 2019), addressed tax affecting in determining the gift tax value of stock in a family owned and operated S corporation, Green Bay Packaging, Inc. (referred to in the court's opinion as "GBP"). GBP is a vertically integrated manufacturer of corrugated packaging, folding cartons, coated labels, and related products, founded in 1933 and headquartered in Green Bay,

Wisconsin. Gifts of stock to younger family members in 2007, 2008, and 2009 resulted in gift tax deficiencies assessed by the IRS. The donors paid those gift tax deficiencies and then filed claims for refund and ultimately sued for refunds in the federal district court in Milwaukee. Both the taxpayers' expert (John Emory of Emory and Co. in Milwaukee, who had been preparing valuation reports for GBP since 1999) and the Government's expert (Francis Burns of Global Economics Group in Chicago) had tax affected GBP's earnings to apply a C corporation level tax to compare the S corporation being valued to C corporations that were used as comparables. For example, the court noted that "[u]nder the income approach, Burns … applied an effective tax rate to GBP as if it were a C-corporation and then applied an adjustment to reflect the value of GBP as an S-corporation." Overall, the court found that "Emory provided reliable valuations of the GBP minority-owned shares of stock" and accepted most of Mr. Emory's conclusions, including his conclusions regarding tax affecting.

(8) **Another Case Allowing Tax Affecting by Looking to Experts, *Jones***. In *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101, the taxpayers' expert, Robert Reilly, tax affected the earnings of an S corporation and a limited partnership by using a proxy for the combined federal and state income tax rates they would bear if they were C corporations, albeit taxed at individual, not corporate rates, in order to adjust for the differences between passthrough entities and C corporations (like the public companies used for comparison in the valuation process). The IRS objected to tax affecting, arguing that there was no evidence that the companies would lose their passthrough status and insisting that the Tax Court had rejected tax affecting in cases such as *Gross v. Commissioner*, *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, and *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141.

In *Jones*, the court explained that prior cases such as *Gross*, *Gallagher*, and *Giustina* did not prohibit tax affecting the earnings of a flowthrough entity per se. The court viewed those cases as concluding that (1) assuming a zero income tax rate on the earnings properly reflected the overall tax savings of operating as an S corporation (*Gross v. Commissioner*), (2) the taxpayer's expert did not justify tax affecting the earnings in balancing the burden of the individual level tax with the benefit of the reduced total tax burden (*Estate of Gallagher v. Commissioner*), and (3) tax affecting the earnings resulted in a post-tax cash flow but the expert applied a pre-tax discount rate (*Estate of Giustina v. Commissioner*). To the contrary, Judge Pugh concluded in *Jones* that the taxpayer's appraiser considered both the advantages as well as the disadvantages of operating as an S corporation and that the taxpayer's expert's "tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate." Judge Pugh viewed the issue as fact-based, and noted that the court in the prior cases had simply concluded that tax affecting was not appropriate for various reasons on the facts of those cases. Judge Pugh appeared to agree that tax affecting had inappropriately become more an issue with examiners and lawyers than a factual inquiry informed by experts and that the experts needed to be listened to. She said (emphasis added):

> While respondent objects vociferously in his brief to petitioner's tax-affecting, his experts are notably silent. The only mention comes in [the IRS's expert's] rebuttal report, in which he argues that Mr. Reilly's tax-affecting was improper, not because SJTC pays no entity level tax, but because SJTC is a natural resources holding company and therefore its "rate of return is closer to the property rates of return". They do not offer any defense of respondent's proposed zero tax rate. **Thus, we do not have a fight between valuation experts but a fight between lawyers**.

To the contrary, based on the evidence in *Jones* Judge Pugh concluded that Mr. Reilly's detailed tax affecting analysis was appropriate:

> We find on the record before us that Mr. Reilly has more accurately taken into account the tax consequences of [the limited partnership's] flowthrough status for purposes of estimating what a willing buyer and willing seller might conclude regarding its value. His adjustments include a reduction in the total tax burden by imputing the burden of the current tax that an owner might owe on the entity's earnings and the benefit of a future dividend tax avoided that an owner might enjoy. … Mr. Reilly's tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate.

Some planners thought that the *Estate of Jones* case might represent a "crack in the 20-year old dam" of the Tax Court's reluctance to recognize tax affecting. Subsequent cases (*Jackson* and *Cecil*) suggest the court is not ready to accept tax affecting as a normal aspect of valuing S corporations.

(9) **A Subsequent Refusal to Tax Affect Based on an Assumption That a C Corporation Was the Most Likely Hypothetical Purchaser, *Estate of Michael L. Jackson*.** One of the issues involved in valuing interests in bankruptcy trusts (NOT a passthrough entity) was whether to "tax affect" the income on an assumption that a C corporation would be the most likely hypothetical buyer and would have to pay a corporate level income tax on the income. The court refused to extend the analysis of *Estate of Jones* and refused to tax affect the income. *Estate of Michael L. Jackson v. Commissioner*, T.C. Memo. 2021-48.

This tax affecting analysis in *Jackson,* though, is quite different from the tax affecting rationale in valuing interests in S corporations under an income method based on a need to adjust the pretax income where capitalization and discount rates are determined from data involving after-tax income of publicly traded corporations (C corporations). In the *Estate of Jackson* case, the rationale of the estate's experts was based on an assumption that "the appropriate hypothetical buyer of each asset would be a C corporation, and therefore, each of them reduced cashflows by the income-tax liability that would be paid by a hypothetical C corporation buyer." However, Judge Holmes concluded that "the Estate has failed to persuade us that a C corporation would be the hypothetical buyer of any of the three contested assets."

Rather than basing a refusal to allow tax affecting merely for that reason, the court distinguished *Jones* (which had allowed tax affecting), viewing it primarily as a case in which the IRS's expert did not contest tax affecting:

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

(10) **Planning Considerations in Making a Tax Affecting Argument.** Valuation experts are critical of the refusal to allow any adjustment to reflect that an S corporation's income is subject to shareholder-level taxes and most appraisers do tax affect the earnings of S corporations despite the Tax Court's reluctance to accept tax affecting. If the appraiser tax affects earnings to be consistent with data available for the capitalization rate used in the capitalization of earnings method or the discount rate used in the discounted cash flow method, the appraisal should address in detail the reasons for doing so. Otherwise, the court will ask why the appraiser adjusted for entity-level taxes when the entity pays no taxes. In addition, the report should take into consideration and balance any benefits that are associated with flow-through status.

The estate's appraisal in *Jones* provides an excellent example of such a detailed approach that considered both the burden on net cashflow by the anticipated individual income taxes on the business income as well as the benefits of passthrough treatment. Mr. Reilly tax affected the earnings of the partnership to reflect a 38 percent combined federal and state income tax that the owners would bear to calculate the net cashflow from the partnership as well as the cost of debt capital that was used to determine an appropriate post-tax discount rate. He also took into consideration the benefit of avoiding a dividend tax, including "by estimating the implied benefit for [the limited parentship's] partners in prior years and considering an empirical study analyzing S corporation acquisitions" and applying a 22 percent premium to the business enterprise value (that was determined both by a weighted discounted cashflow method and by a guideline publicly traded companies method) to reflect the benefit of avoiding the dividend tax. The appraiser used the same tax affecting methodology in valuing an S corporation except that "he used a different rate for the dividend tax avoided because his analysis of the implied benefit for [the corporation's] shareholders in prior years yielded a different rate."

32. Whether, When, and How to Terminate Representation of a Client (Including Ethical Considerations)

This summary is from comments by Bruce Stone (Coral Gables, Florida) at the 57th Annual Heckerling Institute on Estate Planning™.

a. **Restatement of the Law (3d) of the Law Governing Lawyers.** The Restatement of the Law (3d) of the Law Governing Lawyers (Restatement) was initially promulgated in 2000. Professor Jeffrey Hazard, the Reporter, says it is a major piece of legal scholarship that draws heavily on decisional law rather than on ethics codes. Bruce believes "you learn more from reading the Restatement than ever from reading the Rules of Professional Conduct and their comments, as helpful as they are."

b. **Client Can Always Fire Attorney.** A client can always terminate representation at any time, with or without cause. But if the representation involves a court proceeding, the lawyer generally cannot withdraw without court approval.

c. **Not Accepting Representation in the First Place.** "The best way to terminate a client is to refuse to represent the client in the first place." An attorney can refuse to represent a client for any reason, except that lawyers are not immune from legislation outlawing discrimination on grounds such as race. Other than for unlawful discriminatory reasons, though, an attorney can refuse to accept representation for any reason.

   Trust your instincts. If, in interviewing a prospect, the attorney has any thoughts of whether he might sometime want to terminate the client representation, don't take on the client.

   Dennis Belcher once said, "a lawyer is defined as much by the clients the lawyer chooses not to represent as the ones the lawyer does represent."

   Bruce emphasizes the importance of making the sometimes difficult decision at the outset not to accept a client that may likely become a difficult relationship—

   > By far the best way for an estate planner to avoid representation of a person is not to take on the representation in the first place. The estate planner should not succumb to the pressure to generate revenues by taking on the representation of persons the planner instinctively knows she or he probably should not be representing. The short-term revenue benefits will almost always be offset by the noneconomic costs of stress and unhappiness, and in a disproportionate number of situations may be offset by the economic costs of writing off fees and spending money to defend against allegations of malpractice or ethics violations. Except for situations where the ethics rules mandate the lawyer to end a representation because the representation will require the lawyer to violate rules of professional conduct or other law, it should be assumed that a client accepted by the lawyer will remain that lawyer's client until the matter reaches its original contemplated end.

   Keep in mind, though, the lawyer owes certain ethical obligations even to prospective clients. Model Rules of Professional Responsibility (Model Rules) 1.18 (including not revealing information learned from the prospect). Also, the duty of competence may require declining representation. Model Rules 1.1.

d. **Restatement Position Regarding Attorney's Ability to Terminate Client Relationship.** Section 32 of the Restatement summarizes the circumstances in which a lawyer must terminate representation and when the lawyer may be permitted to terminate representation, and the procedures that must be followed in doing so.

   > (1) Subject to Subsection (5), a client may discharge a lawyer at any time.
   >
   > (2) Subject to Subsection (5), a lawyer may not represent a client or, where representation has commenced, must withdraw from the representation of a client if:
   >
   > > (a) the representation will result in the lawyer's violating rules of professional conduct or other law;
   > >
   > > (b) the lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client; or
   > >
   > > (c) the client discharges the lawyer.

(3) Subject to Subsections (4) and (5), a lawyer may withdraw from representing a client if:

(a) withdrawal can be accomplished without material adverse effect on the interests of the client;

(b) the lawyer reasonably believes withdrawal is required in circumstances stated in Subsection (2);

(c) the client gives informed consent;

(d) the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal, fraudulent, or in breach of the client's fiduciary duty;

(e) the lawyer reasonably believes the client has used or threatens to use the lawyer's services to perpetrate a crime or fraud;

(f) the client insists on taking action that the lawyer considers repugnant or imprudent;

(g) the client fails to fulfill a substantial financial or other obligation to the lawyer regarding the lawyer's services and the lawyer has given the client reasonable warning that the lawyer will withdraw unless the client fulfills the obligation;

(h) the representation has been rendered unreasonably difficult by the client or by the irreparable breakdown of the client-lawyer relationship; or

(i) other good cause for withdrawal exists.

(4) In the case of permissive withdrawal under Subsections (3)(f)-(i), a lawyer may not withdraw if the harm that withdrawal would cause significantly exceeds the harm to the lawyer or others in not withdrawing.

(5) Notwithstanding Subsections (1)-(4), a lawyer must comply with applicable law requiring notice to or permission of a tribunal when terminating a representation and with a valid order of a tribunal requiring the representation to continue.

These factors are similar to factors in Model Rule 1.16 (Declining or Terminating Representation).

e. **Two Fundamental Principles.**

(1) **Generally, No Absolute Unconditional Right to Terminate.** With one exception, a lawyer has no absolute unconditional unilateral right to terminate representation of a client without the client's consent. The rationale is that "a lawyer who undertakes a representation ordinarily should see it through to the contemplated end of the lawyer's services when failure to do so would inflict burdens on the client. Accordingly, the general rule is that a lawyer must persist despite unforeseen difficulties and carry through the representation to its intended conclusion, with … limited exceptions …." Restatement §32, comment c.

What are the results of an improper termination? Comment a to §32 of the Restatement explains that a lawyer who withdraws or tries to withdraw from a client relationship, other than as permitted under §32 "is subject to professional discipline (§ 5) and breaches a duty to the client (see § 50)."

(2) **Fiduciary Decision.** A lawyer's act of terminating representation of a client is itself a fiduciary decision. Comments to §16 of the Restatement state explicitly that "the lawyer is a fiduciary." The decision to terminate representation and the manner in which the decision is communicated are still acts of a fiduciary subject to the requirements and constraints of ethics rules.

f. **Exception When Lawyer May (Indeed, Must) Terminate the Client Representation, Without Conditions.** Subsection (2) of §32 of the Restatement sets forth the circumstances in which the attorney must terminate the client representation:

(1) The representation will result in the lawyer's violating rules of professional conduct or other law [i.e., the representation will result in the **lawyer** – not the client – violating laws];

(2) The lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client; or

(3) The client discharges the lawyer.

If continued representation will result in the lawyer's violating rules of professional conduct or other laws, the lawyer has the absolute right (indeed, the requirement) to terminate the representation, subject only to obtaining court permission if the representation is in a court proceeding.

g. **Termination Permitted Absolutely If Certain Conditions Satisfied.** Subsection (3)(a)-(e) lists conditions under which a lawyer is absolutely permitted to terminate the client relationship.

(1) **No Material Adverse Effect of Client Interests.** The attorney may terminate the client relationship if there are no material adverse effects on the interests of the client. **In that situation, the attorney does not have to give a reason and does not need to have any reason at all.**

But determining that there will be no material adverse effects on the client may be difficult, and that determination must be correct, must be made in good faith, and must be reasonable. For example, comments to the Restatement add that the client might have to spend so much time searching for another lawyer that termination would prejudice the client's situation, the client may have to pay duplicative fees to a successor lawyer to become familiar with the matter, confidential information may be so highly sensitive that the client would be reluctant to hire another lawyer and make the disclosure again, a statute of limitations may be looming, or an equally competent lawyer for that particular representation may not readily be available. The attorney wishing to terminate the relationship may be able to ameliorate some of these reasons (for example by reducing or refunding fees that have been paid or assisting the new attorney with getting up to speed without charge).

Withdrawal from the relationship in this circumstance should be allowed even if it is a breach of an employment agreement with the client because any damages should be nominal. Even so, be careful in withdrawing from an engagement if there is no written engagement letter giving the attorney the right to withdraw from the engagement.

(2) **Informed Consent.** Subsection 3(c) of §32 of the Restatement permits the attorney to terminate the relationship if the client gives informed consent. Rule 1.0 of the Model Rules defines informed consent regarding a proposed course of conduct. The lawyer must communicate adequate information and an explanation about the material risks of and reasonably available alternatives to the proposed course of action. Comments to the Model Rules add that the lawyer should disclose facts giving rise to the situation, material advantages and disadvantages of the proposed course of action, and a discussion of alternatives available to the client.

(3) **Criminal, Fraudulent, or Breach of Client's Fiduciary Duty.** Subsection 3(d) of §32 of the Restatement allows the attorney to terminate the relationship if the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal, fraudulent, or in breach of the client's fiduciary duty. Such belief must be reasonable (and, as with the other determinations, be made in a fiduciary capacity). If the attorney is in a court proceeding, the attorney cannot withdraw without first obtaining the court's permission. Can the attorney describe to the court the reasons that the lawyer believes the client is proceeding with a course of action that is criminal, fraudulent, or in breach of a fiduciary duty of the client? Probably not because the attorney still owes ethical duties to the client, including the duty of confidentiality (but there are limited exceptions).

(4) **Perpetrate a Fraud.** Subsection 3(e) of the Restatement provides a similar rule if the client is using the lawyer's services to perpetrate a crime or fraud.

h. **Situations in Which Termination Is Allowed but Only with a Balancing Analysis and Communication (If Feasible) with the Client.**

(1) **Repugnant/Imprudent Action, Not Paying Fees, Irreparable Breakdown, Other Good Cause.** Subsection 3(f)-(i) of §32 of the Restatement describe circumstances not as serious as those listed above, and Subsection (4) says that a balancing analysis is required by the attorney before the attorney is permitted to terminate the client relationship in those circumstances. These situations are listed as follows:

(f) the client insists on taking action that the lawyer considers repugnant or imprudent;

(g) the client fails to fulfill a substantial financial or other obligation to the lawyer regarding the lawyer's services and the lawyer has given the client reasonable warning that the lawyer will withdraw unless the client fulfills the obligation;

(h) the representation has been rendered unreasonably difficult by the client or by the irreparable breakdown of the client-lawyer relationship; or

(i) other good cause for withdrawal exists.

(2) **Balancing Analysis; Communication with Client.** The attorney may not terminate the client relationship if the harm to the client if the attorney withdraws from the relationship would significantly exceed the harm to the attorney or others if the attorney does not terminate unless the client gives informed consent to the withdrawal. If there is any doubt about whether the harm to the client would significantly exceed the harm to the attorney, the attorney should seek informed consent.

But even if the attorney reasonably believes the harm to the attorney would significantly exceed the harm to the client, the Restatement still says the attorney "**must** seek to protect the interests of the client by communicating, if feasible, with the client concerning the basis for withdrawal and requesting any corrective action that the client might be able to take." Restatement §32, comment e (emphasis added). (Comment n similarly says the attorney "**must** consult with the client.")

Bruce offers this further recommendation in such communication:

> However, you must be very careful in having the discussion with the client about withdrawal not to create even the appearance of trying to coerce your client into following your advice. Whether or not you ask the client to consent to termination of the representation, it would be highly advisable for you to consult with another attorney (preferably one with expertise in ethics matters) before telling the client that you are terminating the representation without the client's consent.

(3) **Example – Client Refusal to Follow Advice to Reduce Estate Taxes Substantially.** An "imprudent" action could be refusing to follow the attorney's advice (for example a $50 million client facing huge estate taxes refusing to do anything other than simple estate planning documents leaving everything to his children outright.)

Decision to terminate analysis:

(i) Continuing the representation does not result in the attorney violating any rules of professional conduct or other laws, so there is no unconditional right (or obligation) to terminate the representation.

(ii) If there is no material adverse effect on the client's interests, the attorney may withdraw. This depends on the facts. Adverse effects on the client in circumstances particular to the client could include engaging new counsel at additional expense to bring the new attorney up to speed, loss of time, appraisals becoming stale, etc. Will the adverse effects be "material"? Who determines that? Would the test be whether a disinterested lawyer would reasonably determine whether a material adverse effect exists?

(iii) If neither of those situations applies, this situation may fall within the "imprudent" action reason allowing withdrawal after balancing whether the harm caused to the client by the withdrawal would significantly exceed the harm to the attorney for not withdrawing.

(a) **Balancing Analysis.** The potential harm to the attorney could be quite significant. There have been various cases in which disgruntled family members in this type of situation sued the attorney after the client's death for not insisting that the client engage in transactions that would have resulted in substantial estate tax savings. *See Savu v. SunTrust Bank*, 668 S.E.2d 276 (Ga. Ct. App. 2008); *Gunster Yoakley & Stewart, P.A. v. McAdam*, 965 So.2d 182 (Fla. 2d DCA 2007). In both of these cases, summary judgment was granted in the attorney's favor, but the attorneys in these types of situations would no doubt suffer substantial attorneys' fees, loss of billable time, stress, etc. Bruce says Johnny Cash's tune should come to mind – "I hear the train a comin', it's rolling round the bend."

(b) **Informed Consent.** If there is any doubt after doing the balancing of harm analysis, the attorney could seek the client's informed consent to the attorney's withdrawal.

(c) **Communication of Reasons for Withdrawal and Possible Corrective Actions.** Even if the balancing analysis results in a determination of greater harm to the attorney, the attorney should then communicate with the client the reasons for the withdrawal and suggest corrective actions the client could take. In any event, in this type of situation, the attorney should prepare a detailed communication to the client, and have it signed by the client (to prove the client received it). The communication should state the attorney's advice, that the client refused to follow the advice, and that so much harm would occur by refusing to follow the advice that the attorney has no alternative but to withdraw from the representation. The communication should be in clear, concise, plain English that any non-lawyer could understand, and it should be free of any negative comments about the client or the client's reasoning (no "you're going to be sorry" comments).

(d) **Documentation of Advice (In Part to Protect the Attorney).** If the attorney does decide to proceed with the representation, the attorney should carefully document the advice to the client, list the consequences that could arise from the client's refusal to follow the advice (i.e., the financial harm that could result to the client's children). The communication should be clear and concise and leave no doubt that the client is knowingly refusing to follow the attorney's sound advice and is instructing the attorney to draft simple documents. That written communication is addressed to the client, but in reality it is intended for the plaintiff's lawyer who the children will consult after the client's death about suing the attorney for malpractice, for the judge if the case is pursued, and for the jury if the judge lets the case go to the jury. It is very important that the attorney has indisputable proof that the client actually received the communication, so the client should physically sign a copy of that written communication, which the attorney will carefully preserve in electronic or hard files.

(e) **Release Not Appropriate.** Should the attorney also have the client waive and release any malpractice claims the client and beneficiaries might have against the attorney for proceeding to draft the simple documents without following the other advice even though the attorney thinks it is not malpractice? No. The waiver and release would likely be invalid as to the children because the client cannot waive whatever causes of action they may have. Furthermore, the waiver is probably worthless as to the client if the attorney does not send the client to an independent attorney to advise the client about waiving causes of action in a release that the attorney drafted. "It just doesn't smell right, and if it doesn't smell right, don't do it." In fact, the release is not needed. The written communication signed by the client should be a complete defense against malpractice claims, which is even better than a release of claims.

(4) **Example – Declining Mental Capacity.** The estate planning attorney suspects that the long-time client can clearly see that the client's mental capacity has declined. The longer the decline goes, the more likely that the client will lack capacity, and will be seriously subject to undue influence. The family situation is difficult, and the children and their spouses are hostile to each other. That is a tough situation for the planner; the attorney may ultimately become embroiled in family litigation.

(a) **Maintain Normal Relationship as Far as Possible.** Under the law of agency, the incompetence of a principal terminates the agent's authority, but that is inappropriate as applied to a lawyer's duty to protect the rights of a client with diminished capacity. "If representation were terminated automatically, no one could act for the client until a guardian is appointed, even in pressing situations." Restatement §31, comment e.

(b) **Termination of Client Relationship.** If the attorney nevertheless wishes to terminate the client relationship, is that possible? Unilateral termination is not available absolutely because the lawyer will not be required to violate the Rules of Professional Conduct or other law, the representation could cause material adverse effects on the client, and the client cannot give informed consent. After a guardian or legal representative is appointed, the attorney may be more readily able to terminate (the material effects on the client may be less and informed consent – of the guardian – may be possible). The attorney may fall within the circumstances in which termination can occur after the balancing analysis is applied (i.e., unreasonably difficult relationship, irreparable breakdown of the client-lawyer relationship, or other good cause), but the attorney would not be able to communicate the reasons for the withdrawal and alternatives with the client due to the diminished capacity (such communication is required "if feasible").

(c) **Heightened Responsibility.** Bruce emphasizes that

> a lawyer seeking to terminate representation of a client with diminished capacity should have a heightened responsibility to the client. If the client is not able to engage in meaningful discussion with the lawyer about the reasons for the withdrawal, and if the client lacks the capacity to secure new representation, the lawyer would seem to be violating ethical duties owed to the client by terminating representation if there is no guardian or other legal representative with the authority to act on behalf of the client. In that event, the lawyer may find it necessary to seek the appointment of a conservator or guardian for the client, as permitted in Model Rule 1.14(b).

i. **Summary Regarding Terminating Client Relationships.** These are difficult situations. Bruce notes from his favorite television series ever – "I think we are standing in that middle ground between light and shadow, between science and superstition, and between the pit of man's fears and the summit of his knowledge. It is an area called the Twilight Zone."

Bruce summarizes – "There are a lot of monsters out there, ranging from people who would love to tie you up in court, either as a witness or as a defendant. And there are disciplinary authorities out there. These folks can all get you. So please tread carefully."

33. Judicial Philosophy and Tax Law

a. **Introduction.** On Tuesday, January 10, 2023, Judge Maurice B. Foley of the United States Tax Court delivered the Lloyd Leva Plaine Distinguished Lecture, titled "What's Under the Robe?" Judge Foley, who served as Chief Judge of the Tax Court from June 2018 through May 2022, began by acknowledging how working with Lloyd Leva Plaine, along with Pam Schneider and Carol Harrington, in connection with the GST tax and chapter 14, impacted him and contributed to shaping his judicial philosophy. Judge Foley thanked them. He said that although his judicial philosophy is discernable from his opinions (especially his dissents), this was the first time he had ever specifically spoken in public about his judicial philosophy.

b. **Education.** One of five children of a Postal Service worker, Judge Foley received a Bachelor of Arts degree from Swarthmore College; a Juris Doctor from University of California, Berkeley School of Law; and a Masters of Law in Taxation from Georgetown University Law Center. He became interested in tax law and tax policy when he was a junior in college and took a course co-taught by Political Science Professor Richard L. Rubin, who made an impression on him regarding the subjects of tax policy and the role of taxation as the intersection of political policy and economics. Judge Foley was impressed, for example, by the idea of enterprise zones, targeting tax rules to meet people's needs. Professor Rubin remained a mentor to Judge Foley for a long time after that.

Judge Foley told Professor Rubin that he wanted to be a tax lawyer. Professor Rubin had been in business before joining the Swarthmore faculty and had been the petitioner in a Tax Court case. At his encouragement, Judge Foley read the case, in which Richard Rubin had been represented by Marty Ginsburg, *Rubin v. Commissioner*, 51 T.C. 251 (1968), *rev'd and rem'd*, 429 F.2d 650 (1970), *on remand*, 56 T.C. 1155 (1971). In that case (although Judge Foley did not discuss these details), Dorman Mills, Inc., a family-owned West Virginia textile company, purchased about half of its fiber requirements from Rubin Bros., Inc., a New York company that had been established and built by Richard Rubin's family. After the death of the second-largest shareholder of Dorman Mills, Richard arranged for measures to strengthen Dorman Mills' finances, including a purchase by Rubin Bros. of some of the estate's Dorman Mills shares, an option by Richard himself to purchase Dorman Mills shares from the largest shareholder, Richard's guarantee of a Small Business Administration loan to Dorman Mills, and involvement of Richard and Park International, Inc. (a corporation Richard had formed) in the management of Dorman Mills. The IRS, citing sections 61 and 482, determined that certain management fees paid by Dorman Mills, and related expenses, reported by Park International should have been allocated instead to Richard. In holding for the IRS in the Tax Court, Judge Fay ignored section 482 and applied a substance-over-form analysis under section 61. Marty Ginsburg encouraged Richard to appeal to the Court of Appeals for the Second Circuit. The appeal was successful, in that the Second Circuit repudiated the form-over-substance ground, reversed the Tax Court's judgment, and remanded for consideration consistent with its holding. On remand, the IRS won again, but on the basis of section 482, not on the notion of substance-over-form.

The Tax Court's original approach, ignoring section 482 for a form-over-substance approach, did not make sense to Judge Foley, who, even in college, was developing what he described as a "disdain for judge-made law."

Following his newly-discovered dream, Judge Foley went to law school to become a tax lawyer. In law school he had to digest a complex set of rules about the tax treatment of entities. He noticed that the rules referred to an office in the IRS to contact for more information. In due course, he applied for a job with the IRS, which he saw as good preparation "to do tax planning for athletes and entertainers." He got the job, and the IRS assigned him to what was then known as "L&R" (the office responsible for Legislation and Regulations).

c. **At the IRS.** In L&R, Judge Foley was assigned to Branch 4, which had responsibility for excise taxes and the estate and gift tax. When a volunteer was needed to work on the regulations necessitated by the GST tax enacted in 1986, he volunteered when no one else did. As a result, he ended up speaking at ABA Section meetings and similar settings, and that resulted in his making a video on the GST tax with Lloyd Leva Plaine and Pam Schneider. He knew the rules the IRS was developing, but, as he was often the youngest member on the various panels, he wanted his co-panelists to help him identify issues. He got a lot of calls from practitioners. He had an experienced and very careful reviewer at the IRS, from whom he learned to pay attention to wording, commas, placement of clauses, and the like. But he also learned the importance of being careful about exceeding the limits of the IRS's authority, requiring him to always ask himself "What did Congress say?"

While working on regulations (the "R" part of L&R), Judge Foley was also exposed to legislation (the "L" part). He attended drafting sessions, supposedly to help identify issues of administrability, although administrability rarely came up. He remembers sitting around a table to consider proposed legislative provisions that he found to be "a dizzying array of technical terms and cross-references." He was also involved in providing input to technical corrections.

d. **At the Senate Finance Committee.** Then he was hired to serve on the staff of the Senate Finance Committee. As a newcomer, he got assigned to areas that no one else wanted, such as individual taxation, cost recovery, credits like earned income credits, and the estate and gift taxes. Again, he saw the intersection between politics and economics.

One reason the Finance Committee hired Judge Foley was to help with the repeal and replacement of section 2036(c), which had been enacted in 1987. In that role, he again worked with ABA groups and others, as he was putting together a Finance Committee draft, matching it with the House Ways and Means Committee draft, and coming up with a compromise, which became chapter 14.

Meanwhile, Judge Foley was exposed to the workings of the Tax Court and how the Finance Committee viewed the role of Tax Court judges. He learned that the Finance Committee was very clear about the role of the judge in the tax world: it did not want to confirm judges who would disturb what the Finance Committee had done, rather than leaving it to the Committee to fix problems. This particularly arose in the context of confirmation hearings for Tax Court judges that President Bush had nominated. As examples, Judge Foley displayed slides with the following dialogues from the confirmation hearings for Judges Renato Beghe, Carolyn Chiechi, and David Laro:

Confirmation Hearing for Judge Beghe (March 21, 1991)

The CHAIRMAN [Senator Lloyd Bentsen (D-Texas)]. Let me get a feel for your philosophy as a judge. Suppose you had a case before you and, from your point of view, the literal interpretation of the law would provide for a glaring loophole in the payment of taxes. Let's say it looked like an unjustified tax shelter. How would you interpret it? Would you use a literal interpretation or would you try to close the loophole? … Is it our job or is it the judge's job to close that loophole if the literal interpretation is such that you deemed it to be a real loophole, but apparently it was intended by Congress?

Mr. BEGHE. If the language is clear and unambiguous as applied to the facts of the particular case, the conclusion may very well be that what some people call a loophole actually does exist, and it would be necessary to so hold and bring the matter to the attention of Congress to enable it to decide whether it wanted to remedy the situation.

The CHAIRMAN. All right. Senator Packwood.

Senator PACKWOOD [the Ranking Member of the Committee, Senator Bob Packwood (R-Oregon)]. I think I agree with his answer.

The CHAIRMAN. Well, I think I do too.

Senator PACKWOOD. It is not the court's job to be closing loopholes that we have left open if we have clearly left them open.

The CHAIRMAN. That is right.

Confirmation Hearing for Judges Chiechi and Laro (August 4, 1992)

The CHAIRMAN [Senator Bentsen]. Let me get a question to you that would get to your philosophical viewpoint on the interpretation of the law. Do either of you believe in interpreting the tax law literally as it is written, even though you might find it creates a loophole, or do you think that you should address that loophole and try to interpret it to close it?

Ms. CHIECHI. I believe in interpreting the tax law, pursuant to the language that you and the Congress have used in writing the statute. If the language of the statute is not clear, I would look to the legislative history to find the congressional intent. If the language is clear, and if some may think that it creates a loophole, it would be, in my judgment, the job of Congress and not of the judiciary to close that loophole.

The CHAIRMAN. Mr. Laro?

Mr. LARO. I concur.

e. **At Treasury.** When President Clinton appointed Senator Bentsen to be the Secretary of the Treasury, Judge Foley followed him to Treasury, and his new position brought opportunities to work on certain tax policies of the Clinton Administration, such as the earned income tax credit (13 years after he had heard about it in college) and enterprise zones, which by then were called "empowerment zones."

f. **On the Tax Court.** On April 9, 1995, President Clinton nominated Judge Foley as a judge of the Tax Court. His confirmation hearing was uneventful; the Senators all knew him well.

Noting that in the Tax Court the judge assigned to a case writes an opinion and sends it to the chief judge, who decides whether it will be a nonprecedential "Memo" opinion, a full, published "T.C." opinion, or an opinion reviewed by all the judges in conference, Judge Foley said that one reviewed case "glaringly reveals my judicial philosophy." That case was *McCord v. Commissioner*, 120 T.C. 358 (2003), *rev'd sub nom. Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), a case that has been widely discussed at Heckerling Institutes and among estate planners.

(1) **Facts of *McCord.*** In *McCord* (although Judge Foley did not discuss these details either), Charles and Mary McCord of Shreveport, Louisiana, had created a limited partnership, McCord Interests, Ltd., L.L.P. ("MIL"), with their sons. Almost five months later they gave one class of their MIL interests to a school foundation, and almost two months after that they made gifts of their remaining interests in MIL by means of an "Assignment Agreement." The Assignment Agreement used what the Fifth Circuit later described as a "sequentially structured 'defined value clause,'" giving (i) to four generation-skipping trusts, the dollar amount of fair market value in interest in MIL equal to the donors' remaining GST exemption, on a net gift basis; (ii) to the McCords' four sons, $6,910,932.52 of fair market value in interest in MIL, less the amount given

to the generation-skipping trusts, on a net gift basis; (iii) to the Shreveport Symphony, $134,000 of fair market value in interest in MIL; and (iv) to the Community Foundation of Texas, the remaining dollar amount of interest in MIL. About two months after that, all the donees of that transfer executed a "Confirmation Agreement" that translated their gifts into percentage interests in MIL on the basis of an appraisal by Will Frazier of Howard Frazier Barker Elliott (now Stout). The residual percentage interest of the Community Foundation of Texas, which was represented by its own counsel, was determined on that basis to be about 3.6 percent, meaning that every step in the Assignment Agreement had been given effect. The McCords each reported taxable gifts of about $2.2 million.

(2) **IRS Reaction.** On examination, the IRS roughly doubled the value of the partnership interests, refused to respect the valuation clause (citing *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944)), and asserted that each of the McCords had made taxable gifts of about $5.9 million. It acknowledged that the valuation clause in question was not identical to the valuation clause in *Procter*, because it was a "formula" clause that defined how much was given to each donee, while *Procter* involved a so-called "savings" clause that provided for a gift to be "unwound" in the event it was found to be taxable. Nevertheless, the IRS believed the principles of *Procter* were applicable because both types of clauses would recharacterize the transaction in a manner that would render any adjustment nontaxable.

(3) **Tax Court Decision.** In the Tax Court, a majority of the court sided largely with the IRS, finding the taxable gifts by each of the McCords was about $4.7 million. The majority came to this result, after determining the fair market value of the transferred interests, by applying the percentages in the Confirmation Agreement, even though they had been agreed to about two months after the actual gifts. The court avoided the formula issue by seizing on the fact that the Assignment Agreement, as the court put it, "only uses the phrase 'fair market value' and not the phrase 'fair market value as finally determined for Federal gift tax purposes.'"

(4) **Fifth Circuit Decision.** The Court of Appeals for the Fifth Circuit reversed totally, scolded the Tax Court majority soundly, and remanded the case to the Tax Court to enter judgment for the taxpayers. The court said (footnotes omitted):

> The [Tax Court] Majority's key legal error was its confecting sua sponte its own methodology for determining the taxable or deductible values of each donee's gift valuing for tax purposes here. This core flaw in the Majority's inventive methodology was its violation of the long-prohibited practice of relying on post-gift events. Specifically, the Majority used the after-the-fact Confirmation Agreement to mutate the Assignment Agreement's dollar-value gifts into percentage interests in MIL. It is clear beyond cavil that the Majority should have stopped with the Assignment Agreement's plain wording. By not doing so, however, and instead continuing on to the post-gift Confirmation Agreement's intra-donee concurrence on the equivalency of dollars to percentage of interests in MIL, the Majority violated the firmly-established maxim that a gift is valued as of the date that it is complete; the flip side of that maxim is that subsequent occurrences are off limits.

(5) **Acknowledgment of Judge Foley.** In his Heckerling lecture, elaborating on his point that *McCord* "glaringly reveals my judicial philosophy," Judge Foley pointed out that the Fifth Circuit then added:

> In this respect, we cannot improve on the opening sentence of Judge Foley's dissent:
>
> > Undaunted by the facts, well-established legal precedent, and respondent's failure to present sufficient evidence to establish his determinations, the majority allow their olfaction to displace sound legal reasoning and adherence to the rule of law.

For good measure, the Fifth Circuit also added the explanation that

> Judge Foley's use of "olfaction" is an obvious, collegially correct synonym for the less-elegant vernacular term, "smell test," commonly used to identify a decision made not on the basis of relevant facts and applicable law, but on the decision maker's "gut" feelings or intuition.

The only judge who had joined Judge Foley's dissent in *McCord* was Judge Chiechi. But Judge Foley assured the Heckerling audience that the Tax Court is collegial, even when its opinions are divided.

g. **Conclusion.** Judge Foley's conclusion for the Heckerling audience was simply that "judicial philosophy is a big deal." His was shaped by his experience at the IRS – learning the limits of the IRS's authority. He saw where that line was drawn. In *McCord* he was looking at that line. His personal opinion was irrelevant.

Indeed, Judge Foley had concluded his dissent in *McCord* by stating that "our role and duty are to interpret and adhere to the rule of law – even if uncomfortable with the result."

h. **Comment.** Like the Heckerling audience, we really appreciate Judge Foley's willingness to share with such candor. Reading cases with an appreciation of "judicial philosophy" can be helpful. It is important to remember, however, that not all judges may have the identical view, and, even among judges with shared views, determining the details of what Congress meant and what constitutes a "loophole" may have subjective elements and results that differ from judge to judge and from case to case.

Although Judge Foley, understandably, did not mention issues currently before the Tax Court, some of his reminders about the importance of determining the "limits" of the IRS's authority are seen being played out in the current challenges, for example, to the IRS's rulemaking and other pronouncements, as judged by the requirements of the Administrative Procedure Act. See Item 21 above.

34. Trustee Removal; Trust Modification

The following observations are based on a presentation by Craig Frankel (Atlanta, Georgia) and a panel discussion by Mr. Frankel, Michael Barker (Richmond, Virginia), and Jaclyn Feffer (New York, New York).

a. **Overview of Seven Alternative Methods for Removing Trustee.** This excellent brief summary in this paragraph is taken almost verbatim from the paper by the panelists. The first three methods are nonjudicial or judicial modification alternatives that could include adding trustee removal/appointment procedures. Cases in several states have held that the removal statutes provide the exclusive methods for removing trustees, but most states allow trust modifications to provide methods for removing trustees. (One such recent case is *In Re: Trust Under Deed of Walter R. Garrison*, J-57A-2022, J-57B-2022, J-57C-2022 (Middle District, Sup. Ct. Pa. January 19, 2023).) The remaining methods are based on specific trustee removal statutes. These methods are based on provisions in the Uniform Trust Code (UTC) and Restatement (Third) of Trusts (Restatement).

(1) **NJSA, UTC §111.** Non-judicial settlement agreements entered into by the trustee and all interested persons under statutes based on (or similar to) Uniform Trust Code (UTC) § 111.

(2) **Nonjudicial Consent Modifications, UTC §411, Restatement §65.** Trust modification under statutes based on (or similar to) UTC § 411 or Restatement (Third) of Trusts § 65, which, depending on the statutory scheme, may be accomplished with or without court approval.

(3) **Judicial Trust Modification, UTC §412, Restatement §66.** Court-authorized modification due to circumstances not anticipated by the settlor under statutes based on (or similar to) UTC § 412 or Restatement (Third) of Trusts § 66.

(4) **Court Removal for Lack of Cooperation, UTC §706(b)(2).** Court-ordered removal under statutes based on (or similar to) UTC § 706(b)(2) for lack of cooperation among co-trustees that "substantially impairs the administration of the trust."

(5) **Court Removal Because of Persistent Failure to Administer Trust Effectively, UTC §706(b)(3).** Court-ordered removal under statutes based on (or similar to) UTC § 706(b)(3), where the court determines that it is in the "best interests of the beneficiaries" because of the trustee's "unfitness, unwillingness, or persistent failure . . . to administer the trust effectively."

(6) **Court Removal for Changed Circumstances AND Removal in Best Interest of Beneficiaries, UTC §706(b)(4), Restatement §66.** Court-ordered removal under statutes based on (or similar to) UTC § 706(b)(4) or Restatement (Third) of Trusts § 66 where there has been a "substantial change in circumstances" *and* removal is in the best interests of the beneficiaries.

(7) **Court Removal for Cause or Serious Breach of Trust, Common Law, UTC §706(b)(1), Restatement §37.** Court-ordered removal for cause or "serious breach of trust" under common law or statutes based on (or similar to) UTC § 706(b)(1) or Restatement (Third) of Trusts § 37. This is the most expensive and most time-consuming option (and thus it is listed last).

Other trust modification methods, not directly related to trustee removal, include decanting and trust divisions, UTC §417.

b. **Necessary Parties.** Necessary parties under the various methods vary but consist of some combination of (1) the settlor, (2) the trustee, and (3) beneficiaries (or under the Uniform Trust Code, "qualified beneficiaries").

c. **Representation.** For purposes of delivering required notices and obtaining necessary consents for any of the modification tools, there are rules governing who represents minors, unborns, incapacitated beneficiaries, beneficiaries whose identity and/or location are unknown, permissible appointees under a power of appointment (in the unlikely event that they are qualified beneficiaries), and takers in default under powers of appointment.

The representative can be either an actual or virtual representative. An actual representative is determined based on the individual's relationship with the represented party. A virtual representative is based on an individual's holding substantially identical interests in the trust as the represented beneficiary.

The theory of *virtual representation* is that if an individual has a substantially identical interest, the person will represent his own interests and in doing so will adequately represent others with identical interests. Virtual representation can be either horizontal (the person represented is in the same class or has the same level of beneficial interest as the representative) or vertical (the person represented has a beneficial interest that is successive to the representative's interest – meaning that first tier remaindermen can represent second or third tier remaindermen).

The representative must not have a conflict of interest with respect to the particular question at issue in the modification. In addition, a settlor may never represent a beneficiary in a nonjudicial consent modification (NJSA).

d. **NJSA, UTC §111.**

(1) **General Requirements.** Under §111 of the Uniform Trust Code, nonjudicial settlement agreements (1) require the consent of all "interested persons" whose consent would be required in order to achieve a binding settlement were a court to approve it, (2) require that the change "does not violate a material purpose of the trust," and (3) can only include terms and conditions that could be properly approved by court. Item (3) is not particularly important because a court would likely approve anything that does not violate a material purpose of the trust.

(2) **Material Purpose.** A key requirement is that the agreement does not violate a material purpose of the trust. What constitutes a material purpose is very unclear; it seems to be whatever you can convince the judge.

(3) **Necessary Parties.** "Interested persons" must be parties to the agreement. The Uniform Trust Code is intentionally vague about who are "interested persons." The determination depends upon the nature of the modification. For almost any changes, the consents of beneficiaries will be required. (For some things a trustee's consent is needed, and for some things the consent of a settlor if living is required.)

Observe that the consent of the settlor is not always required. This is an important distinction from the requirements of nonjudicial consent modifications under UTC §411.

(4) **Permissible Scope of Modification.** The Uniform Trust Code has a nonexclusive list of six matters. The common thread of this list is that, except for the first one, they do not deal with dispositive provisions. The six items are matters relating to (1) interpreting or construing the terms of the trust, (2) approving a trustee's report/accounting, (3) directing the trustee to refrain from performing a particular act or granting the trustee a necessary or desirable power, (4)

resignation/appointment of trustee and determination of trustee compensation, (5) transfer of the trust's principal place of administration, and (6) liability of the trustee for an action taken relating to the trust.

Some states have an exclusive list of permitted modifications (primarily administrative matters) because of a perceived potential for abuse.

(5) **Living Settlor Not Required.** This tool is particularly helpful in situations in which there is not a living settlor.

e. **Nonjudicial Consent Modifications, UTC §411(a), Restatement §65.**

(1) **Distinguishing Characteristics.** Nonjudicial consent modifications require the consent of the **settlor** and all beneficiaries. Trustee consent is generally not required (and that can be very helpful where it is not possible to get trustee consent). All types of modifications are allowed.

(2) **Broad Scope Permitted.** All modifications are allowed, even if inconsistent with the material purpose of the trust (under the theory that the settlor's consent is required).

(3) **Not All Beneficiaries Consent.** Even if all beneficiaries do not consent, a court may approve the modification if the court is satisfied that: (i) "(1) if all of the beneficiaries had consented, the trust could have been modified or terminated under this section"; and (ii) "the interests of a beneficiary who does not consent will be adequately protected." UTC §411(e).

f. **Judicial Modification Due to Changed Circumstances, UTC §412, Restatement §66.** Judicial modification based on changed circumstances is a very common approach for a court modification of trusts, but very few cases have considered trustee removal under these types of statutes.

The court may modify administrative or dispositive terms if, because of circumstances not anticipated by the settlor, modification will further the purposes of the trust, and to the extent practicable, the modification must be made in accordance with the settlor's probable intent. UTC §412(a).

In addition, administrative terms may be modified merely by a determination that continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration. UTC §412(b).

g. **Court Removal for Lack of Cooperation, UTC§706(b)(2).** This provision is typically used if there are co-trustees, and trustees are at an impasse, and the trust agreement has no provisions for breaking the impasse.

h. **Court Removal Because of Persistent Failure to Administer Trust Effectively, UTC §706(b)(3).** This is a very broad rationale for removal, but the standards under this section are easier to meet than the standards for removal for cause.

i. **Court Removal for Changed Circumstances AND Removal in Best Interest of Beneficiaries, UTC §706(b)(4), Restatement §66.** UTC § 706(b)(4) also provides for removal when "there has been a substantial change in circumstances or removal has been requested by all of the beneficiaries, the court finds that removal of the trustee best serves the interests of all of the beneficiaries, and is not inconsistent with a material purpose of the trust, and a suitable cotrustee or successor trustee is available."

j. **Communication.** Beneficiary dissatisfaction with a trustee often evolves from a lack of communication. Discussions with the trustee of why certain actions have or have not been taken and reasons why those actions are taken in looking out for the interests of all beneficiaries may help in repairing (or at least improving) the trustee-beneficiary relationship.

Intermediate methods, short of removal, may ameliorate dissatisfaction. Before instituting a removal action, have serious discussions about disagreements over information being provided, distribution patterns, or investment decisions. The parties may be able to reach agreement.

k. **Disputes Between Trustees.** If individual trustees consistently disagree and each seek court modification to name that person as the exclusive trustee, the court is likely to remove both individual trustees and appoint an institutional trustee.

References. For a discussion about state law alternatives for trust modifications, see Items 66-75 of ACTEC 2012 Summer Meeting Musings found **here**, and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** For discussions about the tax effects of settlement and trust modifications see Item 18 of Heckerling Musings 2017 found **here** and Items 42-51 of ACTEC 2015 Annual Meeting Musings found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**