BESSEMER TRUST

LOOKING AHEAD – Estate Planning in 2024, Current Developments & Hot Topics

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Introduction

This LOOKING AHEAD summary addresses planning trends and important estate planning issues for 2024, including various current developments in 2023 and 2024. It includes some observations from the 58th Annual Heckerling Institute on Estate Planning™ that was held January 8-12, 2024, in Orlando, Florida.

3. Summary of Top Developments in 2023

Although Ron Aucutt (Lakewood Ranch, Florida) did not write a separate "Top Ten" report for 2023, he listed the following as his top ten developments in 2023:

(1) Thorough discussion of valuation approaches, tax affecting, and appropriate lack-of-marketability and lack-of-control discounts regarding the famous, closely-held, Biltmore Company (*Estate of Cecil*) (see Item 19 below);

(2) "Substantial compliance" analysis for gift tax adequate disclosure requirements (*Schlapfer*) (see Item 12 below);

(3) Corporate Transparency Act explanations and filing extensions (see Item 8 below);

(4) Consent to judicial modification adding trustee discretionary reimbursement power for grantor's payment of income tax on grantor trust income treated as a gift by trust beneficiaries (CCA 202352018) (see Item 7 below);

(5) Estate tax treatment of life insurance owned by a closely-held company, and a buy-sell agreement that failed the §2703(b) tests (*Connelly v. United States*, U.S. Sup. Ct.) (see Item 29 below);

(6) Updated actuarial tables, with full election back to May 1, 2019 (T.D. 9974) (see Item 4.k below);

(7) Creative, but questionable and troublesome, extension of personal estate tax liability to beneficiaries and a successor trustee of a revocable trust who received trust assets and trust distributions after the decedent's death (*United States v. Paulson* 9th Cir.) (see Item 21 below);

(8) Basis of assets in a grantor trust at the grantor's death (Rev. Rul. 2023-2) (see Item 4.c below);

(9) IRS rejects decanting of QTIP trusts to permit charitable distributions at the spouse's death, but folds when Tax Court pushes back (*Estate of Horvitz*) (see Item 18 below); and

(10) Gift to charity followed quickly by a sale triggers the anticipatory assignment of income doctrine to deny a charitable deduction (*Hoensheid*) (see Item 20 below).

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

4. Trending in 2024

a. **Estate Planning 101 and 201.** Basic estate planning, including preparation of wills or revocable trusts (which will likely include appropriate trust planning for management and creditor protection), powers of attorney, health care documents, and coordination of life insurance, retirement benefits and other non-probate assets will always be of primary importance for the bulk of the population. For clients with estates larger than $5 million (indexed), in case the exemption amount decreases to that (about $7 million) in 2026, planning to minimize federal estate tax will also be important. For couples, this will include bypass trust planning, or portability planning (or a combination of the two). See Item 9 below regarding planning for moderately wealthy clients.

b. **Transfer Planning to Utilize "Bonus Exclusion."** Will the exclusion amount decrease to $5 million (indexed) in 2026? Some commentators have maintained that "no serious planner is predicting … the [$10 million (indexed)] basic exclusion amount … will be preserved." Redd, *Emerging Topics and Trends to Follow*, TRUSTS & ESTATES at 7 (Jan. 2024). Others were just as adamant the large exclusion amount will be extended by Congress (some saying the exclusion amount has never gone down before, which is not exactly true; while the estate tax exemption amount has rarely decreased from

1916 when the estate tax was enacted, it did go down from $100,000 to $50,000 in 1932-1933, and decreased again from $50,000 to $40,000 in 1935-1941; but after increasing to $60,000 in 1942, the estate tax exemption amount has never decreased).

Following the Republican sweep of the Presidency, the Senate, and House in the 2024 elections, it seems highly likely that the large exclusion amount will be preserved (at least for some limited number of years). But, there is some small chance that Congress will not act to prevent the exclusion amount from going down in 2026. Clients may want to take advantage of the difference (the "bonus exclusion") in case the exclusion amount drops in 2026 (from over $14 million to over $7 million). To make use of the "bonus" amount, the client must make a gift of well over $7 million; for example if an individual makes a gift of about $7 million in 2024 and if the exclusion amount goes down to about $7 million in 2026, the individual will have simply used up his or her $7 million amount and will have made no use of the "bonus" amount. For individuals with over about $30 million or couples with over about $60 million, they may (with an emphasis on "may") be able comfortably to afford making transfers of the exclusion amount, but clients having less than that will likely want to retain ways to keep some type of retained cash flow from or discretionary access to the transferred assets. Or a couple may want just one spouse to make a gift to utilize his or her bonus exclusion amount.

(3) **Cushion for Access to Assets for Lifestyle Needs.** A key aspect of large gifts to utilize the bonus exclusion is financial planning to leave an appropriate cushion of the client's lifestyle needs. An important part of any planning is to give clients assurance that sufficient assets will be available for their lifestyle needs for life.

(4) **Spousal Lifetime Access Trust (SLAT).** One alternative may be for one spouse to make a gift to a trust for descendants, but of which the other spouse is a discretionary beneficiary. If the proverbial "rainy day" hits, distributions could be made to the spouse-beneficiary. The planner must be very sensitive to matrimonial law issues (the SLAT transaction can result in a very substantial wealth shift between the spouses.) Also, the transfer must be made entirely from one spouse's property to the trust of which the other spouse is a discretionary beneficiary. In light of the Republican sweep in the 2025 elections, there may be much less focus on creating SLATs in 2025 than previously anticipated. For further discussion about SLAT planning, see Item 11.k below.

(5) **Other Transfers With Continued Possible Indirect Access.** Couples making gifts of a large portion of their $13.61 million (in 2024) 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.**

(6) **Non-Reciprocal Trusts.** Very careful planning is required to avoid the reciprocal trust doctrine if both spouses want to create SLATs for the other spouse. Substantial differences should exist between the trusts. Possible differences include time of creation (separation by months), assets, values, distribution standards, consideration of outside assets, one spouse may become beneficiary only after a specified time or event or upon someone else's exercise of discretion, unitrust provision, termination dates or events, remainder beneficiaries, powers of appointment, trustees, removal powers, etc. For a discussion of non-reciprocal trust planning see Item 80 of the ACTEC 2020 Annual Meeting Musings (March 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

(7) **Sales to Grantor Trusts.** Gifts to grantor trusts followed by sales of assets to the trust continues to be a powerful wealth transfer planning tool. GST exemption can be allocated to the gift, so the trust is GST-tax-exempt, including all appreciation from the assets sold to the trust. See Item 11.j below. For a general discussion of sales to grantor trusts, see Aucutt, *Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts* (September 2023)

found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

(8) **GST Planning.** Donors of large gifts will probably also want to take advantage of the large GST exemption (in case it is also reduced in 2026). The transfer tax savings for future generations could be massive.

(9) **Topping Off Gifts.** Clients who have previously made gifts of the gift exclusion amounts may want to "top off" their gifts to utilize the increase in the gift exclusion amount that occurs each year by inflation adjustments. The gift exclusion amount increased by $860,000 in 2023 and $690,000 in 2024, leaving the possibility of substantial topping off gifts.

(10) **Defined Value Clauses.** Clients making gifts of most or all of their gift exclusion amount will have no "cushion" if the IRS asserts that the values are greater than anticipated, resulting in gift tax being due. To guard against that result, donors making large gifts will consider using defined value clauses. See Item 10 below.

(11) **Adequate Disclosure Reporting on Gift Tax Returns.** Gifts will be reported on gift tax returns to start the period for the IRS to contest the values reported on the return. *Schlapfer v. Commissioner* was the first case in over two decades with a detailed analysis of the requirements for adequate disclosure under the "adequate disclosure" regulations. See Item 12 below.

c. **Ownership Planning in 2025 to Facilitate Gifts in 2026.** If one spouse does not own sufficient assets to make large gifts and both spouses have the same amount of unused gift exclusion, the propertied spouse could make a gift large enough to utilize both spouses' exclusion amounts and the spouses could make the split gift election (the split gift election treats all gift made during the year as if made equally by both spouses). If the propertied spouse has already used much of his or her gift exclusion, property transfers could be made to the non-propertied spouse to allow him or her to be in a position to make gifts if desired by that spouse. However, *Smaldino v. Commissioner* treated a gift by one spouse to the other followed by gifts to a trust for descendants the next day as an indirect gift from the initial transferor spouse. Tread carefully to avoid the step transaction doctrine (or an indirect gift doctrine). Planning considerations include allowing significant time lapse between the gifts (hence, the suggestion to make appropriate property transfers in 2024 to facilitate gift giving in 2025), transferring different assets and amounts than the subsequent gift, and having absolutely no restrictions of understanding that the donee spouse will use the transferred property to make gifts. For a discussion of *Smaldino* and planning considerations see Item 41 of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

e. **Corporate Transparency Act.** Planning regarding corporate transparency act reports will be a big issue during this first reporting year. The individuals who must be reported as beneficial owners will be clear in by far most of the cases, but significant uncertainties exist when trusts are beneficial owners as to what individuals must be reported. See Item 8 below.

f. **Decanting and Trust Modification; Governing Law Issues.** Modification of trusts by decanting, nonjudicial modification, or judicial modification transactions continues to be a growing trend to accommodate changing circumstances. Planners have traditionally been very sensitive to the GST tax effects of modifications, but a trend is that planners will be more sensitive to gift tax issues for consenting beneficiaries. Item 7 below discusses CCA 202352018 in which the IRS took the position that consent by beneficiaries to a judicial trust modification to add a discretionary power of the trustee to reimburse the grantor for the income tax paid with respect to grantor trust income constituted a gift by the consenting beneficiaries. See Item 7 below for a discussion of CCA 202352018 and resulting planning considerations.

A "modification" alternative often considered is moving the trust situs to a different jurisdiction that might have more favorable substantive laws about a relevant issue. The Uniform Law Commission is currently working on a project regarding conflicts of laws for trust matters. The project is about one-third complete and still has several years before completion. For a discussion of governing law issues for trusts, see Item 10 of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

For a discussion of substantive law effects of the various nonjudicial modification alternatives, see Items 66-75 of ACTEC 2012 Summer Meeting Musings found **here,** and tax effects of trust modifications are discussed at Item 34 of Heckerling Musings 2023 (April 12, 2023) found **here**, Item 18 of Heckerling Musings 2017 found **here**, and Items 42-51 of ACTEC 2015 Annual Meeting Musings found **here**, all available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

g. **Trust Structuring for Flexibility.** Structuring trusts with provisions for flexibility to accommodate changing circumstances is a continuing trend. Planning considerations include using independent trustees with wide discretion for distributions, the creative use of powers of appointment, using trust protectors with wide powers beyond just trustee removal powers, flexible decanting powers, and the ability to make adjustments for divorce protection of beneficiaries. For a discussion of various trust planning and drafting pointers to build in flexibility for trusts (including a number of creative alternatives for using powers of appointment and trust protectors), see Item 11 of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

h. **Directed Trusts.** The use of directed trusts continues to grow in popularity. The settlor can designate certain persons (or entities) to be responsible for investment decisions (generally or for specific assets) and to make distribution decisions (generally or for certain special distributions). For a a more detailed discussion of directed trusts, see Items 95-104 of ACTEC 2019 Annual Meeting Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

5. Legislative Developments

a. **FY 2025, FY 2024, and FY 2023 Greenbooks;.** Tax legislative proposals from the Biden Administration were summarized in "General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals" (popularly called the "Greenbook"), released March 1 2024 (see **https://home.treasury.gov/system/files/131/General-Explanations-FY2025.pdf**), are very similar to the transfer tax and trust provisions in the FY 2024 (FY24) Greenbook. Many of the provisions of the FY24 Greenbook were similar to items in the FY 2023 and FY 2022 Greenbooks, but the FY24 Greenbook included 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-FY25 Greenbooks, see Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (March 2024) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** The following is a brief overview of highlights of the FY23-FY25 Greenbooks (the new proposals in the FY24 Greenbook are noted). The FY25 Greenbook is very similar to the FY24 Greenbook with respect to the issues described below, except as noted otherwise.

The FY25 Greenbook proposals have precious **little chance of being enacted** into law with a split Congress. Ron Aucutt warns "[e]ven 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%
- The FY25 Greenbook would increase the corporate alternative minimum tax rate from 15 to 21 percent
- Increase the corporate stock repurchase excise tax from 1% to 4% (in FY24 Greenbook) (and the FY25 Greenbook would close a loophole regarding foreign corporations)
- 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%; this is an increase from today's lower top rates (23.8% on capital gains, 29.6% on some business income, and over 39% on wages)
- 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, and the FY25 Greenbook adds that a tacking rule would apply for the deemed recognition by trusts and non-corporate entities
- Impose a 25% (up from 20% in the FY23 Greenbook) minimum tax on the income (generally including unrealized gains) on wealthiest taxpayers (similar to what has been referred to as the "Billionaire Income Tax" proposals; Senator Wyden introduced the "Billionaires Income Tax Act" (S. 3367, weighing in at 116 pages!) on November 30, 2023, which would annually tax the value of unrealized gains on assets using mark-to-market taxation for taxpayers with adjusted gross incomes of more than $100 million or assets valued at more than $1 billion, *see* Sword & Wallace, *Mark-to-Market Bill Would End 'Buy, Borrow, Die,' Senator Says*, 181 TAX NOTES FEDERAL 1861 (Dec. 4, 2023)); for a discussion of these similar proposals see Item 2.l 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**.

- OBSERVATION: Bills were introduced in the House and Senate on March 19, 2024, titled the "Ultra-Millionaire Tax Act of 2024" that would impose a 2% annual tax on the net worth of households and trusts between $50 million and $1 billion and a 3% annual tax on the excess value above $1 billion.

- Tax "carried interests" as ordinary income if the partner's taxable income exceeds $400,000 (not indexed)
- Eliminate 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 and Continued in FY24 and FY25 Greenbooks.**

- 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 between deemed owners and grantor trusts (with an effective date for *transactions* after the date of enactment), with a refinement in the FY24 and FY25 Greenbooks that would disallow losses in such transactions
- 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) (with refinements in the FY24 and FY25 Greenbooks)
    - OBSERVATION: S.3988, the "Getting Rid of Abusive Trusts Act (the "GRATs Act") was introduced on March 20, 2024, by Senate Finance Committee Chair Ron Wyden (D.-Ore) and Sen. Angus King, Jr. (I-Maine) on March 20, 2024. It would implement those first three items regarding GRATs (applicable to trusts created on or after and the portion of trusts attributable to contributions on or after the date of enactment), sales between deemed owners and grantor trusts (applicable to transfers after the date of enactment), and the grantor's payment of income tax on grantor trust income (applicable to trusts created on or 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 ($14 million in the FY 25 Greenbook, up from $13 million in the FY24 Greenbook)
- Extend the 10-year estate and gift tax lien during any deferral or installment period
- 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, changed to 2025 in the FY25 Greenbook); The FY24 Greenbook adds that 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 and FY 2025 Greenbooks.** Some startling new transfer tax and trust proposals are included in the FY24 Greenbook and continued in the FY 2025 Greenbook.

- Defined value formula clauses to determine the value of gifts or bequests that depend on some activity of the IRS would 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 would be effective for transfers by gift or at death after 2023 (changed to 2024 in the FY25 Greenbook).
- "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 would be effective for gifts after 2023 (changed to 2024 in the FY25 Greenbook).
- Several proposals impact GST tax issues:
    - A purchase of assets from a GST-tax-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;
    - Although under current law, charitable entities are treated as assigned to the transferor's generation under §2651(f)(3) and §501(c)(3,) charities would not be counted as having an interest in the trust for purposes of delaying a taxable termination (§2652(c)(1)(B)); the proposal would also to exclude §501(c)(4)s (and other designated exempt organizations) as having an interest in the trust for that purpose; and

- Loans from a trust to a beneficiary would be treated as a distribution for GST tax purposes and a refund of GST tax paid as a result of such deemed distribution could 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 would apply 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 would 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 with 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.

(7) **Bold Transfer Tax Legislative Proposal.** Bold transfer tax provisions provided funding in the American Housing and Economic Mobility Act of 2024, introduced in the Senate by Senator Warren (D-MA) (S. 4824, July 29, 2024) and in the House by Representatives Cleaver (D-MO) (H.R. 9245, August 2, 2024) (similar to legislation that has been proposed in prior years). The proposal includes very bold transfer tax changes:

- Increased estate and gift tax rates (55% up to $13 million, 60% between $13 million and $93 million, and 65% over $93 million, and additional 10% surtax over $1 billion)
- Estate and gift exclusion reduced to $3.5 million (reverting to the 2019 amount, without inflation adjustments)
- GRATs would have a minimum 10-year term (with no decrease in the annuity during the first 10 years) and a remainder interest equal to at least 10% of the value transferred to the GRAT
- Grantor trust assets are (i) subject to gift tax to the extent distributed during the grantor's life or to the extent grantor trust status terminates during the grantor's life and (ii) otherwise included in the grantor's gross estate for estate tax purposes (adding §2901)
- GST exemption would only cover transfers to grandchildren or others assigned to their generation (not more remote beneficiaries) and to beneficiaries born before the creation of the trust
- Gift tax annual exclusion "simplified" by eliminating the present interest requirement and replacing it with a per-donor annual limit of twice the per-donee limit (indexed, now $36,000) on the total of transfers (i) in trust (including trusts with "Crummey powers," with no exception for "vested" single-beneficiary trusts), (ii) of interests in passthrough entities, (iii) of interests subject to a prohibition on sale, and (iv) of property that "cannot immediately be liquidated by the donee" (ignoring withdrawal, put, or other such rights)
- No basis step-up for assets in grantor trusts that are not in the transferor's gross estate
- Valuation discount limitations for interests in entities controlled by the transferor, the transferee, or their families or for non-business assets
- Income tax surcharge on high income estates and trusts (5% of modified AGI over $200,000 and an additional 3% for modified AGI over $500,000); ; "modified AGI" is AGI reduced by investment interest that is not deducted in determining AGI and by amounts paid or set aside for charity under §642(c)
- Increased potential special use valuation adjustment under §2032A from $750,000 (indexed, now $1,390,000) to $3 million (inflation adjusted going forward)
- Increased limit on exclusion of the value of conservation easements under §2301(c) from $500,000 to $2 million

b. **Additional IRS Funding from Inflation Reduction Act.** The Inflation Reduction Act of 2022 included $79.6 billion of additional long-term IRS funding available until September 30, 2031. Included

amounts were $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 was 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 would reduce the deficit by over $300 billion over a decade (a Penn Wharton analysis estimated 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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> ...
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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 have decried the legislation as a reckless threat to the economy. Senator Rick Scott (R-FL) 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).

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

The additional IRS funding (especially funding allocated to enforcement) has been very controversial, in particular with House Republicans. In fact, the Fiscal Responsibility Act of 2023 (the debt-ceiling legislation that President Biden signed on June 3, 2023) rescinded $1.39 billion of the IRA's long-term funding, and reportedly one condition of its dramatic negotiation was a commitment to repurpose an additional $10 billion of that funding in each of Fiscal Years 2024 and 2025, raising serious concerns about the durability and trustworthiness of the funding.

Debt ceiling negotiations in the summer of 2023 between President Biden and then-House Speaker Kevin McCarthy resulted in a hand-shake deal to redirect portions of the additional IRS funding, trimming $10 billion out of the enforcement allocation in fiscal 2024 and an additional $10 billion in fiscal 2025. Under the continuing resolution adopted by Congress on January 18, 2024, for funding the government through the beginning of March 2024, the $10 billion reallocation for fiscal year 2025 is accelerated to fiscal year 2024, resulting in reallocating $20 billion from the enforcement portion all in fiscal 2024. *See* Cady Stanton, *IRS Spending Stays Flat in Plan to Avert Shutdown*, 182 TAX NOTES FEDERAL 532 (Jan. 15, 2024).

Interestingly, a study titled "A Welfare Analysis of Tax Audits Across the Income Distribution" found that IRS audits of high-income taxpayers provides an estimated 12-to-1 return of each dollar spent on an audit of the taxpayer. Their estimated returns are vastly higher that the roughly 2.5-to-1 return estimated by the Congressional Budget Office in its analysis of the effects of the additional IRS funding under the Inflation Reduction Act. *See* Jonathan Curry, *IRS Sitting on Gold Mine of Potential Revenue, Study Suggests*, TAX NOTES (June 16, 2023) (for each dollar spent, audits of taxpayers in the 70th to 80th percentiles produce a return of $9.06, and audits of taxpayers in the 90th to 99th percentiles yield $12.48, including the deterrent effect on the audited taxpayers in future years).

A Congressional Budget Office report in February 2024 estimates that a $20 billion rescission of IRS funding would reduce revenues over 10 years by $44 billion and increase the cumulative deficit by $24 billion. A $35 billion rescission of funding would reduce revenues by $89 billion and increase the cumulative deficit by $24 billion.

Estimates by independent researchers of revenue losses from IRS funding cuts are much higher. An analysis by Natasha Sarin (associate professor at Yale Law School and Yale School of Management) and Mark Mazur (former director of the Urban-Brookings Tax Policy Center) estimates that the $21 billion of enforcement resources that have already been rescinded from the Inflation Reduction Act funding for enforcement will decrease revenue by about $280 billion over the next decade. "Ironically, this costly rescission – negotiated as part of the debt ceiling agreement – will worsen fiscal sustainability rather than address it." Natasha Sarin & Mark Mazur, *The Inflation Reduction Act's Impact on Tax Compliance and Fiscal Sustainability*, 182 TAX NOTES FEDERAL 1397 (Feb. 19, 2024).

A report of the Treasury Inspector General for Tax Administration dated January 29, 2024, summarizes how the additional IRS funding has been expended through September 30, 2023. Treasury Inspector General for Tax Administration, QUARTERLY SNAPSHOT: THE IRS'S INFLATION REDUCTION ACT SPENDING THROUGH SEPTEMBER 30, 2023, REPORT NUMBER: 2024-IE-R007 (January 29, 2024). The Inflation Reduction Act authorized additional IRS funding of about $79.4 billion, and Congress reduced that by about $1.4 billion, reducing the supplemental funding to about $78 billion, available through September 30, 2031. The IRS has expended about $3.5 billion of the supplemental funding through September 30, 2023; $1.4 billion of that was spent in the last quarter of FY 2023 (July–September 2023). Nearly $2 billion of the $3.5 billion, has been used to supplement the IRS's FY 2023 annual appropriation due to budget shortfalls not covering normal operating expenses. Of the $3.5 billion, only $299 million (or just 8.7%) has been expended on enforcement matters; the balance has gone to taxpayer services (25.7%), operations support (43.4%), and business systems modernization (22.2%). Of the total $79.4 billion funding boost in the Inflation Reduction Act, 57% was allocated to enforcement. Clearly, the IRS is way behind at this point in expenditures to supplement enforcement. The report observed that "it has been widely reported that the IRS will be hiring 87,000 armed enforcement agents," but the only enforcement personnel who are armed are special agents in Criminal Investigation, and they comprise only about 15% of enforcement personnel. Total enforcement staffing on September 3, 2023, was 13,498, and the goal is to increase staffing by a net of 5,462 personnel, or a 40.5% increase, by September 30, 2024.

The February 2024 Congressional Budget Office report mentioned above similarly observed that through 2023, the IRS hired fewer revenue agents (the enforcement staff who handle complex audits) than it had planned. That shortfall suggests that the IRS has encountered greater difficulty in hiring auditors than it anticipated. CBO expects that the IRS will be able to use all the mandatory

funding that it designated for hiring in later years, but because of the delays in hiring and training new auditors, revenue collections from enforcement activities are smaller in CBO's February 2024 projections than they were in its previous projections.

Informal reports are that the IRS Engineering Program (which houses real property and business appraisers) had about 250 employees in October 2022, and the goal is for it to have about 400 technical employees by March 2024. A former head of business valuation nationally for the IRS concludes that FY 2024 and FY 2025 will be major training years. Michael Gregory, *Funding Changes at the IRS Affect How to Handle Valuations*, Trusts & Estates 41 (Feb. 2024).

The IRS taken steps to utilize the additional funding for enforcement and has added to its headcount for enforcement (including adding estate and gift tax examining officers). The additional funding for taxpayer services and business systems modernization may be retained, but the additional enforcement funding has been controversial with Republicans. All the additional headcount may not be retained if the additional enforcement funding is rescinded. *See* Benjamin Valdez, *Election Results Cast Doubt on Fate of IRS Funding, Direct File*, 185 TAX NOTES FEDERAL 1266 (Nov. 11, 2024).

The IRS funds from the Inflation Reduction Act for enforcement are dwindling.

> The agency initially received $45.6 billion in enforcement funds from the IRA, reduced to about $24 billion as of June 30 because of the clawbacks over the past two years. With $805 million of that funding spent as of June 2024, freezing an additional $20 billion leaves — at most — $3 billion in enforcement funding from the IRA for the IRS to use.
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> The agency estimates it will spend $2.3 billion in IRA funds on enforcement in fiscal 2025, according to a quarterly snapshot report from the Treasury Inspector General for Tax Administration released October 3, after spending about $300 million in fiscal 2023 and an estimated $1.05 billion in fiscal 2024.

Cady Stanton & Doug Sword, *Frozen IRS Enforcement Dollars at Stake in Budget Stopgap*, 185 TAX NOTES FEDERAL 2249 (Dec. 16, 2024).

A continuing resolution to extend government funding at 2024 fiscal levels until March 14, 2025, does not release the $20.2 billion clawback of enforcement funds, which means those funds remain frozen until a full-year appropriation agreement can be reached. *See* Cady Stanton, *$20B in IRS Enforcement Funds Set to Remain Frozen Into March*, TAX NOTES TODAY FEDERAL (Dec. 18, 2024). Similarly, a continuing resolution extending government funding that was enacted on December 21, 2024 does not release the $20.2 billion of enforcement funds.

The damage to the IRS efforts of increased enforcement may already be seriously hampered because of the funding uncertainty.

> "I think the signal is being sent that the freeze would turn into a rescission," Janet Holtzblatt of the Urban-Brookings Tax Policy Center said. "So the question isn't just that we may never get that $20 billion back. You're sending a bad signal to managers in the IRS for their hiring and contracting goals."
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> …
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> But these professionals read and hear about what is going on with IRS funding.
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> "If you're on the outside and you've got the skills to do those audits of sophisticated partnerships and you haven't accepted the offer yet, would you?" Holtzblatt asked.

Cady Stanton & Doug Sword, *Frozen IRS Enforcement Dollars at Stake in Budget Stopgap*, 185 TAX NOTES FEDERAL 2249 (Dec. 16, 2024).

d. **Tax Legislative Impacts of Republican Sweep in 2024 Elections; What Will Happen to the Estate and Gift Tax Basic Exclusion Amount?** The Republican sweep of the Presidency and majorities in the Senate and House in the 2024 elections (the "Republican trifecta") will lead to major anticipated legislative changes.

(1) **Extremely Brief Overview of Tax Proposals.** The Republicans' primary tax focus will be to make permanent the individual and business income tax cuts and the transfer tax cuts in the 2017 Tax Act. Most of those provisions would otherwise sunset on January 1, 2026. (As

discussed below, however, most of those cuts would only be extended for 10 years, or even less, because of the legislative "reconciliation" process.)

The Trump campaign has not identified its position on transfer taxes other than extending the 2017 Tax Act cuts (i.e., keeping the exclusion amount at $10 million, indexed for inflation).

The Trump campaign has also suggested additional cuts at various times including cutting the corporate income tax rate to 15% and providing income exclusions for tips for certain industries, overtime pay, and social security payments.

(2) **Financial Impact**

The nonpartisan Congressional Budget Office estimated (in May 2024) that extending all the 2017 Tax Act cuts would add $4.6 trillion to the deficit over ten years (2025-2034). It estimated that extending the $10 million (indexed) estate and gift tax exclusion amount for ten years would add $167 billion to the deficit and would increase net interest outlays by another $22 billion (total cost of $189 billion). *Budgetary Outcomes Under Alternative Assumptions About Spending and Revenues*, CONGRESSIONAL BUDGET OFFICE (May 2024).

Adding in other possible changes suggested by the Trump campaign, including exempting overtime pay from taxation, repealing the state and local tax deduction limitation (which reduces revenues over ten years by $1.2 trillion, as discussed below), offset somewhat by additional broad tariffs, would add $7.75 trillion over ten years to the deficit according to the Committee for a Responsible Federal Budget. *The Fiscal Impact of the Harris and Trump Campaign Plans, US Budget Watch 2024*, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET (Oct. 28, 2024).

(3) **Do Tax Cuts Pay for Themselves?** Deficit estimates often take into consideration the effects of economic growth resulting from tax cuts. In 2017, the Joint Committee on Taxation scored about a 30% offset from economic growth resulting from the 2017 Tax Act tax cuts, but the Tax Foundation currently estimates a more modest 16% offset from economic growth. William McBride, *Questions About Tax Cuts, Tariffs, and Reconciliation After the Election*, TAX FOUNDATION (November 13, 2024) (estimating that extending the 2017 Tax Act cuts would add about $4.25 trillion to the deficit over ten years on a conventional basis, but by about $3.59 trillion after including economic growth effects, representing a 167% offset), available at **https://taxfoundation.org/blog/trump-tax-cuts-tariffs-reconciliation/**.

Republican leaders have stated that the Congressional Budget Office underestimated by $1.5 trillion in 2017 how much revenues would grow under the 2017 Tax Act. *See* Doug Sword, *House Leans Toward Two Bills With Tax Second, Budget Chair Says*, TAX NOTES TODAY FEDERAL (Dec. 18, 2024) (statement by House Budget Committee Chair Jodey Arrington (R-Texas)). The CBO acknowledged the underestimation but blames $900 billion of the underestimate on higher than expected inflation and much of the rest on Trump tariffs that were not projected at the time. *Id.*

A recent report from the Committee for a Responsible Budget, a nonpartisan fiscal watchdog group, concludes that an extension of the 2017 Tax Act tax cuts would do little to grow the economy.

> New data from the Congressional Budget Office (CBO) finds that economic feedback may not cover *any* of the revenue loss and that TCJA extension might even add ***more to the debt on a dynamic basis, particularly over the long run,*** than under conventional scoring.
>
> … CBO finds that "the dynamic budgetary effects of [TCJA] expiration … would be very similar to the conventional estimate," as ***the positive effects of lower taxes would be counteracted by the negative effects of higher debt.***

TCJA Extension Might Not Pay for Any of Itself, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET (December 10, 2024) (emphasis in original), available at **https://www.crfb.org/blogs/tcja-extension-might-not-pay-any-itself**.

A study by economists at Harvard, Princeton, and the University of Chicago concluded that the TCJA lower corporate tax cuts did stimulate more corporate investment, but they estimated that

the law would cause the economy to grow 1% larger over 10 years, generating roughly $750 more in wages for each American worker, less than the $4,000 per employee that had been predicted by the Trump administration. The study concluded that this largest corporate tax cut in U.S. history would result in a long-run increase of domestic corporate capital but would produce small dynamic revenue effects; it would increase corporate income and labor payments, but the extra tax revenue from that activity would be offset by the higher cost of depreciation deductions, which would be immediately expensed. Chodorow-Reich, Gabriel, Owen Zidar, and Eric Zwick. 2024. *Lessons from the Biggest Business Tax Cut in US History*, JOURNAL OF ECONOMIC PERSPECTIVES (2024).

Even so, some members of Congress maintain that "pay-fors" are not required for economic growth provisions (such as tax cuts).

(4) **Deficit Concerns Are Growing.** "In 2001, the U.S. federal government ran a $128 billion budget surplus and was on course to pay off the national debt by 2009." *From Riches to Rags: Causes of Fiscal Deterioration Since 2001*, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET (January 10, 2024). The nation's debt has risen from $4.6 trillion in 2005, to $13.1 trillion in 2015 (in large part, resulting from the financial crisis of 2007-2009), to $36 trillion today. Even without any extension of the tax cuts, "the deficit for the 2025-2034 period is projected to total $22.1 trillion, $2.1 trillion more than the CBO projected in February." *An Update to the Budget and Economic Outlook*: 2024 to 2034, Congressional Budget Office (June 2024); *see* Andrew Duehren, *Trump's Agenda-Three Paths for Taxes*, NEW YORK TIMES THE MORNING (November 15, 2024). Another estimate is that the Congressional Budget Office projects that deficits will average $1.9 trillion per year over the next decade assuming the 2017 Tax Act cuts expire after 2024.

Interest payments on the national debt have grown dramatically. The nation's debt service in 2020 was $345 billion annually when the pandemic relief was being negotiated. Because of the subsequent increase in the debt and the increase in interest rates (the 10-year Treasury notes fell as low as 0.6% in April 2020 and are now at 4.4%), the net interest on the public debt grew to $950 billion in FY24 (a growth of 34% from FY 23). Interest on the public debt is now the second largest federal expenditure after Social Security (which costs $1.5 trillion), surpassing defense spending of $826 billion and Medicare spending of $869 billion. William McBride, *Another Huge Federal Deficit in Fiscal Year 2024 Despite Surging Corporate and Other Tax Collections*, TAX FOUNDATION (October 10, 2024), available at **https://taxfoundation.org/blog/federal-budget-deficit-tcja-revenue-spending/**.

Even with the Republican trifecta, many members of Congress will be concerned about the deficit impact of extending all the 2017 Tax Act cuts for another ten years (and possibly adding other tax cuts as well).

(4) **Thin Political Margins.** There are razor-thin margins in the House and Senate, and some congressmen are deficit hawks who campaigned primarily on reducing the federal deficit. But President Trump can be expected to exert significant pressure on Republicans to stay unified in their voting. House Majority Leader Steve Scalise (R-LA) summarizes it this way: "Donald Trump is the whip now. You don't have to worry about me; I'm actually a nice guy. The guy at 1600 Pennsylvania is going to send out a tweet, a truth, or whatever, and it's not going to be as nice." *See* Doug Sword, *Tax Bill Should Include Tips; SALT Solution Unclear, Scalise Says*, TAX NOTES TODAY FEDERAL (Dec. 11, 2024). Even so, "[t]he paper-thin GOP majority will introduce complications not seen in 2017, leaving little room for disagreement with the ranks…. Last month's government funding debate provided an early taste of what's likely to come." Joseph Boddicker, *When Campaign Promises Meet Political Reality: This Year's Super Bowl of Tax*, 186 TAX NOTES FEDERAL 131 (Jan. 6, 2025).

Another political reality is if passage of the Act is not completed by September, some members of Congress will be going into election season for the 2026 Mid-terms, and reaching compromise will be even more difficult.

(4) **SALT Cap Repeal.** The Trump campaign indicated that it favors repealing the $10,000 SALT cap (on the deduction for state and local taxes), and some members of Congress are very focused on repealing the cap. But the SALT cap has been a potent revenue generator from the 2017 Tax Act. Repealing the SALT cap entirely is estimated to reduce revenue by $1.2 trillion over ten years. *SALT Cap Expiration Could be Costly*, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET (Aug. 28, 2024). A compromise, such as boosting the cap to $15,000 for individuals and $30,000 for joint filers, would reduce the revenue impact by $564 billion over ten years. *Policymakers Must Weigh the Revenue, Distributional, and Economic Trade-Offs of SALT Deduction Cap Design Options*, TAX FOUNDATION (Dec. 7, 2023).

The SALT cap could become a hotly debated issue in the 2025 legislative negotiations. While it has a large revenue impact, the very narrowly divided Senate and House means that a few Congressmen from New York, California, and other high income tax states could threaten to buck the entire reconciliation package without a concession on the SALT issue. *See* Zach Cohen, *SALT Cap Opponents Empowered in Narrow House Majority Next Year,* BLOOMBERG DAILY TAX REPORT (November 18, 2024) ("This is not 2017, this is 2025, and we're going to have a very tight margin, and there are more than enough members as part of the SALT caucus that will be able to exert influence," quoting Rep. Mike Lawler (R-NY)). House Majority Leader Steve Scalise (R-LA) points out that in 2017 Republicans had a large majority and could afford 25 defections and still advance a reconciliation bill; in 2025, the Republicans will hold a very slim majority in the House and 24 of the Republican members of the House are from the five states (California, New York, New Jersey, Illinois, and Minnesota) most affected by the $10,000 SALT deduction limitation. *See* Doug Sword, *Tax Bill Should Include Tips; SALT Solution Unclear, Scalise Says*, 185 TAX NOTES FEDERAL 2256 (Dec. 16, 2024).

(5) **Pay-Fors.** In some years, Congress has adopted a "pay-for" approach, requiring that tax cuts or spending increases must be offset with other tax increases or spending cuts. Soon-to-be Senate Finance Committee Chair Mike Crapo (R-ID) takes the position that extending current tax policy does not require an offset. Furthermore, he has stated that cutting the corporate income tax rate to 15% is an economy-growing policy that does not have to be paid for (but he does not know if the proposed income exclusion for overtime pay, tips and Social Security count as economy growing). *See* Doug Sword & Cady Stanton, *Cutting Taxes is Easy: Paying for It Is Not*, 185 TAX NOTES FEDERAL 329 (Oct. 14, 2024). However, deficit hawks in the House may push for more deficit-conscious legislation.

Offsets are touchy prior to elections. "No one leads with their offsets. Offsets are released later because they are just not attractive." Statement by Joshua Ordintz, former counsel at the Department of Treasury and the Senate Finance Committee. *Id*.

Pay-fors will likely play a big role at crunch time. Ultimately, cost estimates and analyses from the Joint Committee on Taxation will be critical in determining what provisions will be included or excluded from the legislation. Examples of pay-fors that have been mentioned include additional taxes on large endowments and municipal bonds, lowering the mortgage interest deduction, and eliminating state workarounds for the SALT cap. *Id*.

(6) **Reconciliation Legislative Process.** The Senate can pass tax legislation with a mere majority under the reconciliation legislative process enacted in the Congressional Budget Act of 1974. That Act was used for the first half of its existence to *reduce* deficits; starting in 2021, it has been used to grow deficits more than half the times it has been used. *See Budget Reconciliation Should Be Used to Reduce the Debt, Not Add to It*, TAX NOTES TODAY FEDERAL (Nov. 19, 2024) (statement from Maya MacGuineas, president of the Committee for a Responsible Federal Budget).

The process begins in the House with the passage of a budget resolution that specifies a budget window (at least five, but typically ten years), the maximum amount the bill could add to deficits, and general budget instructions for each committee. The budget resolution must then be passed by the Senate.

Negotiations over the deficit amount can be difficult. The $4.6 trillion deficit estimate for a 10-year extension may be too large for many members of Congress to stomach. The budget resolution for the 2017 Tax Act stalled in the Senate for an extended time while negotiating over the deficit number. Congressional leadership had hoped to introduce a budget resolution in May or June 2017, but the House did not pass its budget resolution until October 5, 2017. A bill was introduced on November 2, 2017, and the 2017 Tax Act was enacted on December 22, 2017. (The three-seat Republican majority in the Senate in 2025 is even less than the four-seat majority the Republicans held in the Senate in 2017 when negotiations were delayed for months over the deficit number.)

Thus, one of the most difficult decisions must be made at the outset of the process in adopting a budget resolution. "This brings about an arguably backward process. The first thing House and Senate Republicans must agree on is how much their bill can add to deficits over 10 years. Then they spend that number. 'It's driven by your decision up front about what your budget number is.… You figure out what number you can live with, then you write policy that fits that number — not the other way around.'" Doug Sword, *TCJA's Extension Might Be a Short One*, TAX NOTES (November 13, 2024) (quoting Jonathan Traub of Deloitte Tax LLP).

The budget resolution can specify that a budget reconciliation bill will be considered to "reconcile" the work by various committees working on budget issues and to enforce budget resolution targets. Like the budget resolution, it cannot be filibustered in the Senate and only requires a majority vote. The reconciliation directive directs committees to produce legislation by a certain date that meets specified spending or tax targets. The various bills are packaged into a single bill (only one reconciliation act is allowed in each Congressional session). The reconciliation bill, when ultimately approved by the House and Senate, goes to the President for approval or veto.

While the reconciliation act is not subject to Senate filibuster, under the "Byrd rule" any single Senator can call a point of order against any provision or amendment that is "extraneous" to the reconciliation process for various prescribed reasons, including (1) provisions without fiscal impact or that are merely "incidental" to fiscal impact (the measure can only be for the purpose of implementing budget changes [spending and revenue provisions]; for example, a provision mandating an increase of the minimum wage would not be germane to fiscal matters), (2) provisions that impact Social Security, and (3) any provision that raises deficits beyond the budget window of the reconciliation bill unless other provisions in the bill fully offset these costs.

Scoring rules for determining the fiscal impact of the reconciliation act will become a central discussion point 2025. One significant issue will be whether to use a "current law" (under which tax cuts would expire) or "current policy" baseline. Senator Michael Crapo (R-Idaho), expected to be the Senate Finance Committee Chair in 2025, urges that the cost of tax legislation should be measured against "current policy": "If you're just extending current law, we're not raising taxes or lowering taxes, that is a $4 trillion deficit. That's ridiculous." Andrew Duehren, *Republicans Ponder: What if the Trump Tax Cuts Cost Nothing?*, NEW YORK TIMES (November 25, 2024) (quoting Senator Crapo in an interview with Larry Kudlow). The Obama administration had similarly argued that extending the Bush tax cuts that were set to expire at the end of 2012 should be measured against current policy, not the "current law" under which tax cuts would expire. (The difference between these approaches in 2012 was whether the legislation was deemed to *reduce* the deficit by more than $700 billion over ten years using a current policy approach vs. the Congressional Budget Office estimate that it *increased* deficits by about $4 trillion over those ten years using a current law approach as the baseline. *Id.*)

The Center for American Progress, an independent (but left-leaning) nonpartisan policy institute, strongly argues that a current law baseline should be used and that using a current policy baseline "is a gimmick. That is a double no-count, and no program in the entire budget is officially scored that way." *Republican Tax Legislators' Potential Framework for Extending Trump's Tax Cuts Is a Gimmick That Would Cost More Than Advertised*, REPORT OF CENTER FOR AMERICAN PROGRESS (December 7, 2024).

> But the alternative current policy baseline that some Republicans have proposed—either for rhetorical purposes or for official CBO/JCT scoring and budget enforcement—would change the assumption that the Trump tax cuts that are set to expire under the law to instead assume that they will actually continue. Doing so would make it appear as if a bill extending them is free, despite the fact that an extension of the individual and estate tax cuts would cost taxpayers roughly $3.9 trillion over 10 years that has never been counted, increasing upward pressure on the debt-to-GDP ratio by 50 percent.

Id.

Scoring rules that apply in the reconciliation process can be surprising. For example, additional IRS funding for enforcement may increase revenues by up to 12:1 for auditing high-income earners. However, additional net revenue generated by additional IRS funding cannot be counted in reconciliation, but net revenue losses resulting from defunding the IRS are counted in reconciliation. Tax Analysts Tax Policy Webinar (November 20, 2024) (statement by Chris Towner, policy director for the Committee for a Responsible Federal Budget).

Republicans may make an argument that their plans for deregulation, tariffs, and economy-growing tax provisions mean the bill will pay for itself despite any CBO score (but deregulation and tariffs will not be a part of the reconciliation act). *See* Doug Sword, *House Leans Toward Two Bills With Tax Second, Budget Chair Says*, TAX NOTES TODAY FEDERAL (Dec. 18, 2024).

The Senate Parliamentarian gives advice about the interpretation of Senate rules and procedures including guidance on compliance with requirements of reconciliations acts. The Parliamentarian clearly advises about what matters are "extraneous" under the Byrd rule, which includes whether a reconciliation bill extends deficits beyond the budget window, but the Parliamentarian's decision may not be decisive as to whether the budgetary impact is within the impact number specified in the budget resolution. The Parliamentarian does not determine scoring methods directly, but its interpretations can influence how provisions are assessed for budgetary impact for compliance with reconciliation instructions in the budget resolution.

The negotiation and implementation of a reconciliation act is a cumbersome time-consuming process. "You have to involve the [Congressional Budget Office], you have to involve the budget committees, you have to involve the [Joint Committee on Taxation] . . . they are the arbiters, and I think that's a process." Stanton & Rifaat, *Reconciliation Discord Portends Slow Movement for Tax Extensions*, TAX NOTES TODAY FEDERAL (January 8, 2025) (statement by Jorge Castro of Miller & Chevalier, Chtd.).

One reconciliation act is allowed in each fiscal year (though two reconciliation bills have never been passed in a single calendar year). In 2017, a FY 2017 budget resolution was introduced on January 3, 2017, to repeal various mandates, taxes and penalties associated with the Affordable Care Act (Obamacare), with the hope of enacting legislation in April or May 2017. Negotiations stalled, and that attempt failed. The plan was then to introduce a separate FY 2018 budget resolution sometime in May or June 2017, with the goal of completing the reconciliation act by August 2017, that would deal with tax reform. Similarly, no reconciliation bill has been introduced for FY 2025, so in 2025, two reconciliation acts would be possible (one for FY 2025 and one for FY 2026).

Republican leadership in the Senate and House have differed over whether to plan to pursue one or two reconciliation acts in 2025. House Ways and Means Committee Chair Jason Smith (R-MO) prefers a single bill approach to extend expiring provisions of the 2017 Tax Act and address other tax changes and also to include provisions about securing the border and about energy. He reasons "[t]here are advantages to doing one bill and having the border as part of the sweetner to get 218" (the number of votes for a majority vote in the House). *See* Doug Sword, *Top Republicans Agree to Disagree on 2025 Tax Bill Approach*, 185 TAX NOTES FEDERAL 2253 (Dec. 16, 2024). House Speaker Mike Johnson (R-La.) plans the passage by the end of April and "certainly by May" of one massive reconciliation act addressing issues such as border security, money for mass deportation of undocumented immigrants, extension of the 2017 tax cuts, raising or eliminating the federal debt ceiling, reducing federal regulations, and "dismantling the

deep state." Baumann, *What to Know in Washington: Speaker Bill Plan Faces GOP Pushback*, Bloomberg Government (Jan. 6, 2025).

Senator Lindsay Graham (R-SC), Chair of the Senate Budget Committee, disagrees, explaining that border security alone must be Congress' first order of business and that including everything in one bill will be too cumbersome. *Id.* Senate Majority Leader John Thune (R-SD) also prefers a two-bill approach, with the first bill addressing border security, defense and energy and a second that would focus on taxes. Momentum may be building among House Republicans to begin with a "skinny" reconciliation bill on border security that is fully paid for followed by a second bill dealing with taxes to extend the 2017 Tax Act cuts. *See* Doug Sword, *House Leans Toward Two Bills With Tax Second, Budget Chair Says*, TAX NOTES TODAY FEDERAL (Dec. 18, 2024).

The reconciliation process will likely begin in the early days of the Trump administration. President-Elect Trump has expressed that his top two priorities when taking office are border security and the Trump tax cuts. "We're going to be extending within that period [100 days]—or as soon as we can—the Trump tax cuts…. I think it will anger a lot of people, frankly, if we don't get an extension of that." Quoted in Alexander Rifaat, *Trump Plans to Act Fast on TCJA Extension*, 185 TAX NOTES FEDERAL 2248 (Dec. 16, 2024).

In any event, the Republicans have slim majorities in the Senate and House. But President-Elect Trump can be expected to exert significant pressure on Republicans to stay unified in their voting. House Majority Leader Steve Scalise (R-LA) summarizes it this way: "Donald Trump is the whip now. You don't have to worry about me; I'm actually a nice guy. The guy at 1600 Pennsylvania is going to send out a tweet, a truth, or whatever, and it's not going to be as nice." *See* Doug Sword, *Tax Bill Should Include Tips; SALT Solution Unclear, Scalise Says*, TAX NOTES TODAY FEDERAL (Dec. 11, 2024). Even so, "[t]he paper-thin GOP majority will introduce complications not seen in 2017, leaving little room for disagreement within the ranks. Last month's government funding debate provided an early taste of what's likely to come." Joseph Boddicker, *When Campaign Promises Meet Political Reality: This Year's Super Bowl of Tax*, 186 TAX NOTES FEDERAL 131 (Jan. 6, 2025).

(7) **Shortened Extension to Reduce Deficit Impact.** One way of dealing with the deficit impact of tax cuts is to reduce the period of the extension. The 2017 Tax Act reduced its deficit impact (to $1.5 trillion) by shortening the extension to eight years rather than the full ten years of the budget window. Three ways of reducing the bill's deficit impact are to (i) make it shorter, (ii) make it skinnier by reducing the tax cuts, and (iii) include pay-fors. The two likely approaches in 2025 will be making it shorter and adding some pay-fors (new revenue sources, such as a state and local tax deduction limitation for corporations or an attempt to count tariffs toward a reconciliation score). *See* Doug Sword, *TCJA's Extension Might Be a Short One*, TAX NOTES (November 13, 2024).

Another factor is the political reality of the upcoming 2026 mid-term elections, when the party out of power historically has more success. In 2026, 20 Republican but only 13 Democratic senators are up for reelection. The political reality, then, is that the cuts must last longer than two years, "but a four-year bill might not be prohibitively expensive. 'I'm thinking this is maximum like a four-year extension.'" *Id.* (quoting Marc Gerson of Miller & Chevalier Chtd.). Another prediction: "Three to five years is more likely than eight years," [referring to the eight-year extension of the 2017 Tax Act]. *Id.* (quoting Jonathan Traub of Deloitte Tax LLP).

(8) **Estate and Gift Tax Measures.** The estate and gift tax provisions do not have a big revenue impact in relation to the overall 2017 Tax Act changes. Extending the estate tax measure would increase the deficit by $189 billion over ten years vs. $4.6 trillion for extending all the 2017 Tax Act. But the estate tax provisions are highly charged political issues and are likely to be included in the tax cut extensions. Because of the Byrd Rule, the extensions of the $10 million (indexed) exclusion amount will probably last for only 10 years (or less). It will automatically revert to a lower exclusion amount at the end of that time—whether it will be further extended may depend on how the political winds are blowing at that time.

Not only is it likely that the $10 million (indexed) exclusion amount will be extended, the Republican sweep raises the specter of possible *repeal* of the estate tax. Indeed, Senator John Thune (R-SD), who will be the new Senate majority leader, has repeatedly introduced estate tax repeal bills and initially won his Senate seat in part by running against the "death tax."

The greatly increased likelihood that the $10 million (indexed) exclusion amount will be extended has reduced the perceived pressure on clients to take advantage of the large exclusion amount before it may be slashed in half. Clients who were not totally comfortable making large gifts will likely wait before making gifts to see when Congress will ultimately decide whether the larger exclusion amount will be extended (but they should consider engaging in planning, structuring trusts, etc. currently so the planning will be in place when they decide to make large gifts). Clients who were not totally comfortable making large gifts are probably the clients most interested in implementing transfer panning with SLATS, so we may see less emphasis on SLATs going forward. Clients who were not totally comfortable making large gifts are probably the clients most interested in implementing transfer planning with SLATS, so we may see less emphasis on SLATs going forward. Clients who have enough wealth that they are comfortable making gifts are best advised to make the gifts currently, so that future appreciation can be removed from the estate.

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

In the first Trump term, the administration placed a temporary freeze on regulations projects in an executive order signed January 20 (which is typical for a new administration). The administration on January 30, 2017, also signed an executive order establishing a "one-in, two-out" system for regulations, requiring that for each new regulation, agencies must find at least two to repeal in order to reduce the net regulatory costs. President Trump issued an Executive Order on April 21, 2017, directing Treasury to review all "significant tax regulations" issued on or after January 1, 2016 and identify those that impose undue financial burden or complexity or that exceed statutory authority of the IRS. Will a similar approach to regulations surface in 2025?

a. **2024-2025, 2023-2024, 2022-2023 and 2021-2022 Treasury-IRS Priority Guidance Plans.** The 2024-2025 Treasury-IRS Priority Guidance Plan (dated October 3, 2024) sets the priority for guidance projects during the Plan year (from July 1, 2024, to June 30, 2025), but no deadline is provided for completing the projects. The 2024-2025 Plan adds three new projects in the "Gifts and Estates and Trusts" section.

   (1) Guidance regarding amounts qualifying as distributions of income exempt from estate tax under §2056A (Number 6).

   (2) Regulations under §2642 regarding the redetermination of the inclusion ratio on the sale of an interest in a trust for GST exemption purposes (Number 9). (For example, if G1 creates a trust for G2 and G2 sells its beneficial interest to G3, are trust distributions to G3 taxable distributions? Are they indirect distributions to G2? If G2 sold the interest for fair value, there is no gift so no change of transferor occurs for GST purposes. The New York State Bar Association Tax Section has submitted detailed comments to the IRS regarding this project. *Report on the GST Tax Effect of Assignments of Beneficial Interests*, NEW YORK STATE BAR ASSOCIATION TAX SECTION (Nov. 19, 2024). *See* Bramwell and Weisbart, *The Dueling Transferors Problem in Generation-Skipping Transfer Taxation*, 41 ACTEC L.J. 95 (Spring 2015).)

   (3) Guidance updating the user fee for estate tax closing letters (Number 12). (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. Charging a user fee for closing letters was the only way to keep issuing them at all. Informal indications are that the price will be going down; the IRS has corrected a lot of issues with the closing letter system. Closing letters are obtained through pay.gov.)

   The 2024-2025 Plan deletes one project in the "Gifts and Estates and Trusts" section that was finalized in the last Plan year, extensions to allocate GST exemption (final regulations (RIN 1545-

BH63) were published on May 6, 2024, discussed in Item 4.i below. In addition, Item 7 on the 2024-2025 Plan says that references in Reg. §20.2056A-2 regarding qualified domestic trust elections on estate tax returns were updated in proposed regulations filed August 20, 2024 (Number 6 in the 2023-2024 Plan).

For a general discussion of and commentary about the 2023-2024 Priority Guidance Plan and various items that have been on the Plan in prior years see Item 5 of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (February 2024) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

The following are items regarding gifts and estates in the 2024-2025 Plan.

GIFTS AND ESTATES AND TRUSTS

1. Regulations under §645 pertaining to the duration of an election to treat certain revocable trusts as part of an estate.

2. Final regulations under §§1014(f) and 6035 regarding basis consistency between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016.

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

4. Regulations under §2032(a) regarding imposition of restrictions on estate assets during the six-month alternate valuation period. Proposed regulations were published on November 18, 2011.

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

6. Guidance regarding amounts qualifying as distributions of income exempt from estate tax under §2056A.

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

• PUBLISHED 08/21/24 in FR as REG-119683-24 (FILED 08/20/24).

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. Regulations under §2642 regarding the redetermination of the inclusion ratio on the sale of an interest in a trust for GST exemption purposes.

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. Final regulations under §6011 identifying a transaction involving certain uses of charitable remainder annuity trusts as a listed transaction. Proposed regulations were published on March 25, 2024.

12. Guidance updating the user fee for estate tax closing letters.

Several of the items on the Plan (and on Plans from the last several years) are discussed in more detail below.

Proposed regulations were issued in 2022 with respect to two of the items on the Plan (Numbers 3 [abuse exception to the anti-clawback regulation], and 5 [§2053]). Final regulations were issued for the GST exemption allocation extensions project (Number 8 on the 2023-2024 Plan and deleted in the 2024-2025 Plan) on May 3, 2024. See Item 4.i below.

Cathy Hughes, Treasury Department Office of Tax Policy, at the ABA Tax Section meeting in May 2024, listed four sets of final regulations that were expected by the end of the summer of 2024: (1) basis consistency (Number 2 on the 2023-2024 Plan, final regulations were issued September 17, 2024, discussed below); (2) imposition of restrictions on estate assets during the six-month alternate valuation period under §2032(a) (Number 4 on the 2023-2024 Plan); (3) final regulations under §2801 regarding taxation of gifts or bequests from certain expatriates (Number 9 on the 2023-2024 Plan); and (4) updating obsolete references (presumably Number 6 on the 2023-2024 Plan). Erin Schilling,

Finalized Estate Tax Regulations Expected This Summer, BLOOMBERG DAILY TAX REPORT (May 3, 2024). The basis consistency final regulations and proposed regulations updating obsolete QDOT references have been completed.

The next regulation project from the IRS may be final regulations under §2801 regarding the reporting by U.S. citizens or residents of gifts from "covered expatriates"(as defined in §877A(g)(1)). Planners are anxious to see if the IRS will require gift tax returns reporting such gifts back to §2801's effective date of June 17, 2008.

Apparently, the alternate valuation date final regulations will come later.

b. **Basis Consistency (Number 1).** The basis consistency provisions of §1014(f) and §6035 were enacted as part of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, enacted July 31, 2015. Section 1014(f) provides that for federal income tax purposes the basis of property to which §1014(a) applies (*i.e.*, property acquired from a decedent but with various exceptions) shall not exceed the final value determined for estate tax purposes, or if the final value has not been determined, the value provided in a statement to the decedent's recipients. Section 6035 provides that if the estate is required to file an estate tax return under §6018(a), the executor is required to submit valuation information reports to recipients and to the IRS. Penalties apply (potentially very substantial penalties) if the required reports are not given. These statutory provisions apply to estates for which estate tax returns are filed after the date of enactment (i.e., after July 31, 2015).

Form 8971 and its Instructions were released on January 29, 2016, and revised draft instructions were released in June and in October 2016, with a September 2016 date. No later versions of the Form or Instructions have been issued. Updated information about Form 8971 is posted at **https://www.irs.gov/forms-pubs/about-form-8971**. (It was last updated August 4, 2024 to update where to file Form 8971—at Internal Revenue Service, Stop 824G, 7940 Kentucky Drive, Florence, KY 41042.)

Temporary and proposed regulations regarding §1014(f) and §6035 were published in the Federal Register on March 4, 2016. Various provisions in the proposed regulations were very controversial. The IRS received over thirty written comments about the proposed regulations. ACTEC filed very detailed comments on May 27, 2016, and ACTEC representatives testified at the hearing with the IRS about the proposed regulations.

For a detailed discussion about the legislative history behind the basis consistency provisions, the Form 8971, and the proposed regulations, see Item 5.b of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (February 2024) found **here** and Akers**,** *Basis Consistency Temporary and Proposed Regulations* (March 25, 2016) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights** and Akers, *The Executor's Job Gets Tougher: Basis Consistency and Selected Other Income Tax Issues Facing Executors*, 51st ANN. HECKERLING INST. ON EST. PL. ¶1803.1 (2017).

Treasury officials reported in May 2022 that they were hoping "to get [final regulations] out soon,." but the publication of the final regulations obviously has been delayed. Officials reported in the Spring of 2024 that the final regulations may be coming by the end of the summer of 2024, indeed, the final regulations were issued on September 16, 2024, to be published in the Federal Register on September 17, 2024. (T.D. 9991, 89 FED. REG. 76356, Sept. 17, 2024).

Some highlights from the final regulations are briefly summarized.

(3) **Due Date for Statements to Beneficiaries Reporting Property the Beneficiaries Have Not Yet Acquired.** One of the most controversial provisions of the proposed regulations (that would have been problematic for many if not most estates required to file basis consistency reports) was that "Statements" (Schedules A to Form 8971) had to be provided to all beneficiaries by the earlier of 30 days after the due date of the estate tax return or the date that is 30 days after the date the estate tax return is filed with the IRS. If the executor had not determined what property would be distributed to each beneficiary by that time, the executor had to report on the

Statement for each beneficiary *all* the property that the executor could use to satisfy the beneficiary's interest. Commenters complained that would cause duplicate reporting, may confuse beneficiaries by leading them to expect to receive all the property reported to them, and would require disclosure of private information about many if not most estate assets to all potential beneficiaries (which might result in conflicts and litigation among beneficiaries with competing interests).

Commenters noted that §6035(a)(1) requires the executor to furnish Statements "to each person *acquiring* any interest in property included in the decedent's gross estate," and the common meaning of "acquiring" and the way it is used in other Code sections refers to something already received.

The IRS adopted that interpretation of the term "acquiring," and adjusted the due date of Statements for property that beneficiaries have not received by 30 days after the estate tax return is due or is filed before the due date. The final regulations continue to require that for each beneficiary who acquired property on or before the due date or earlier filing of the estate tax return, the due date of Statements is 30 days after the due date or earlier filing of the return. But the due date for furnishing a Statement to a beneficiary who acquires property at a later date is January 31 of the calendar year following the year of acquisition. (That will give the beneficiary plenty of time to properly report tax information after the beneficiary received the property, for example, reporting income from the beneficiary's sale of the property.) A beneficiary is treated as "acquiring" property when title vests in the beneficiary or the beneficiary has sufficient control or connection with the property that the beneficiary can take action related to the property for which basis of the property is important (such as selling or depreciating the property). That usually occurs when the property is distributed but may occur upon the death of the decedent for property passing by contract or operation of law. Reg. §1.6035-1(c)(4).

If the executor anticipates that a beneficiary will receive certain property, the executor has the option to furnish Statement(s) to any such beneficiaries within 30 days of filing the estate tax return. That could reduce the burden associated with these filing requirements if the executor believes certain beneficiaries will receive particular property. If a different beneficiary ends up receiving that property, the executor must file a supplemental Information Return with the IRS and a revised Statement to the beneficiary. Reg. §1.6035-1(c)(5), §1.6035-(d)(2)(iv). (Such supplemental returns are required within 30 days after information becomes available to conclude that supplemental reporting is required. Reg. §1.6035-1(d)(4).)

Coordinating changes are made to the information that must be included in the initial and supplemental Information Returns (Form 8971). Statements are attached (as Schedules A) for property distributed before the due date or earlier filing date of the estate tax return and Statements that the executor elects to furnish by that date as to property the executor anticipates distributing to particular beneficiaries. Reg. §1.6035-1(c)(1). The Information Return must be filed by the due date even if no Statements are attached. Preamble to Final Regulation, T.D. 9991, 89 FED. REG. 76356, at 76365 (Sept. 17, 2024).

(4) **Removal of Zero Basis Rule for Unreported Property.** The proposed regulations surprisingly took the position that after-discovered or omitted property gets a basis of zero if the property is not reported on an estate tax return before the period of limitations on assessments has expired. Prop. Reg. §1.1014-10(c)(3)(i)(B).

Comments to the IRS argued that the zero basis rule was not authorized by the statute (§1014(f), which applies only to property reported on an estate tax return, the IRS's regulatory authority was to provide exceptions to the basis consistency requirement not to expand basis consistency, and the Code does not support denying at least allowing a carryover basis for an inherited asset). The IRS rejected those arguments.

Comments also urged that the practical effects of the zero basis rule are onerous, unduly harsh, and unfair (beneficiaries do not control reporting on estate tax returns by executors and unreported property is more likely to arise by an inadvertent omission or as a result of being

undiscovered, rather than willful omission). The preamble to the final regulations recognizes those practical effects and also observes that existing Federal tax enforcement mechanisms (including criminal liability) serve to deter willful nonreporting on the estate tax return.

The final regulations delete the zero basis provisions in proposed regulation §1.1014-10(c)(3)(i)(B). The final regulations do not specifically address after-discovered or omitted property, but the preamble to the final regulations addresses the comments about the zero basis rule and concludes with this summary.

> The rule identifying property subject to the consistent basis requirement in §1.1014-10(c)(1)(i) of the final regulations, together with the definition of the term *included property* in §1.1014-10(d)(4) of the final regulations, is sufficient to clarify the scope of the consistent basis requirement, and therefore these final regulations do not include a specific rule on the basis of unreported property.

Preamble to Final Regulations, T.D. 9991, 89 FED. REG. 76356 at 76361 (Sept. 17, 2024) (emphasis included in original).

(5) **Eliminating the Subsequent Transfer Reporting Requirement for All Beneficiaries Other Than Trustees.** The proposed regulations also surprisingly included a subsequent transfer reporting requirement. If a recipient of an asset in the gross estate makes a subsequent gift or distribution to a "related transferee" (which, for some strange reason, included a grantor trust but not a non-grantor trust for a related party) the recipient must file a Schedule A (beneficiary Statements are Schedules A attached to the Form 8971) with the IRS and transferee reporting the change in ownership and final estate tax value of the property. Prop. Reg. §1.6035-1(f).

Comments to the IRS about this requirement included that the IRS lacks authority to require reporting of subsequent transfers, the reporting requirement could continue for generations, the requirement would be impossible for the IRS to monitor and enforce, and the requirement would be particularly unfair to unsophisticated individual recipients who would likely be unaware of the reporting requirement and would be more likely to become subject to noncompliance penalties. The IRS and Treasury reconsidered the benefits and burdens of the proposed subsequent transfer reporting requirement and concluded that the burden of the requirement, including penalties for noncompliance, is too heavy to impose on individual beneficiaries. However, the IRS and Treasury concluded that for trustees of trusts the subsequent transfer reporting requirement would not be sufficiently burdensome to outweigh the needs of and benefits to the IRS and trust beneficiaries. Preamble to Final Regulations, T.D. 9991, 89 FED. REG. 76356, at 76372 (Sept. 17, 2024).

The final regulations omit the subsequent transfer reporting requirement for individual recipients of property that was in Prop. Reg. §1.6035-1(f), but the requirement continues to apply to trustees of beneficiary trusts when they make distributions, including direct distributions to trust beneficiaries and distributions pursuant to the exercise or lapse of a power of appointment (whether general or limited). The subsequent transfer reporting requirement would apply to trustees of trusts that receive property from beneficiary trusts (so the reporting obligation continues until property is distributed to an individual not in trust). But the reporting requirement does not apply to a sale or other transaction that is a recognition event for income tax purposes (whether or not resulting in a gain or loss) if the property's basis is no longer determined by reference to the estate tax value of the property. Reg.§1.6035-1(h)(1), (3).

The subsequent transfer report by trustees is due by January 31 of the calendar year following the year of distribution. Reg. §1.6035-1(h)(2).

Some commenters have noted that the subsequent transfer reporting requirement for trustees will be a burden for individual trustees, many of whom will be unaware of the requirement. See Wallace, *Estate Tax Basis Consistency Regs to Reduce Compliance Burden*, TAX NOTES (Sept. 17, 2024).

(6) **Ability of Beneficiaries to Challenge Value.** Several commenters requested that a procedure be added under which a beneficiary could challenge the determination of final value since the beneficiary has no control over the executor's reporting on the estate tax return or involvement in

any redetermination of value in an examination or court proceeding. The IRS rejected that request because of "[a]dministrability and other concerns," including that it would leave the IRS in the same position of litigating valuation issues with a beneficiary, the same as before the enactment of §1014(f). However, the IRS and Treasury are considering future guidance that may allow a beneficiary to produce "certain credible evidence of value" during some limited period of time "if the credible evidence of value indicates the reported value represents a substantial understatement of value." Preamble to Final Regulations, T.D. 9991, 89 FED. REG. 76356, at 76362 (Sept. 17, 2024).

(7) **Excepting Certain Types of Property From Consistent Basis and/or Reporting Requirements.**

(a) **Estate Tax Returns Filed On or Before July 31, 2015.** The consistent basis provisions of §1014(f) and the reporting requirements under §6035 apply to estates for which estate tax returns are filed after July 31, 2015. The final regulations clarify that the basis consistency and reporting requirements do not apply to estates for which the estate tax return was filed on or before July 31, 2015, even if the due date of the return is after July 31, 2015 or if one or more supplements to the return are filed after July 31, 2015. Reg. §1.1014-10(c)(1)(ii); §1.6035-1(b)(1).

(b) **Overview of Types of Excepted Property.** The proposed regulations provide as exceptions to the consistent basis requirement only property that qualifies for the marital or charitable deduction and tangible personal property for which an appraisal is not required under §20.2031-6(b). Prop. Reg. §1.1014-10(b)(2). The proposed regulations provided four exceptions of types of property that do not have to be reported under §6035: (i) cash (other than a coin collection or other coins or bills with numismatic value); (ii) income in respect of a decedent; (iii) tangible personal property for which an appraisal is not required; and (iv) property sold or disposed of in a transaction in which capital gain or loss is recognized. Prop. Reg. §1.6035-1(b)(1).The final regulations add clarifications and add some types of excepted property.

(c) **Property *Wholly* Deductible Under Marital or Charitable Deductions.** Property qualifying for the estate tax marital or charitable deduction is not subject to the consistent basis provisions of §1014(f) (but generally is subject to the reporting requirements under §6035). The final regulations clarify that property qualifying for only a *partial* marital or charitable deduction is not excepted from the consistent basis requirement. The preamble to the final regulations lists several examples:

> (1) a charitable remainder trust, a charitable lead trust, or a pooled income fund; (2) a trust subject only to a partial QTIP election under section 2056(b)(7); and (3) property divided between the decedent's surviving spouse and a charity if the sum of the deductions for the two interests given to those recipients is less than the value of the property included in the value of the gross estate.

Preamble to Final Regulation, T.D. 9991, 89 FED. REG. 76356, at 76358-59 (Sept. 17, 2024). As to that third example, the actual language of the final regulation is broad enough to include property divided between two charities if the sum of the deductions is less than the gross estate value, as occurred in *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17. Reg. §1.1014-10(c)(2)(xi).

(d) **Taxable Termination Property Subject to GST Tax and Surviving Spouse's One-Half Community Property Interest.** The consistent basis and reporting requirements apply only to property included in the decedent's gross estate. The proposed regulations provided a long list of items not included in the gross estate and therefore not subject to the requirements. The final regulations add several additional exceptions.

i. **Taxable Termination Property Not Subject to Consistent Basis.** The final regulations add that property subject to a taxable termination for GST tax purposes is not in the gross estate and therefore is not subject to the consistent basis requirement. Reg. §1014-10(c)(2)(xiii).

ii. **Spouse's One-Half Interest Community Property Interest Not Subject to Consistent Basis and Reporting Requirements.** The surviving spouse's one-half of community property is not in the decedent's gross estate for estate tax purposes and therefore is not subject to the consistent basis and reporting requirements. Reg. §1014-10(c)(2)(xii); §1.6035-1(e)(1). If the executor makes a non pro rata division and distribution of community property under applicable state law, property included in the decedent's gross estate that is distributed to the surviving spouse in lieu of the spouse's interest in community property pursuant to state law must be reported on the Information Return and on a Statement to the spouse. Reg. §1.6035-1(e)(1).

(e) **Cash**. The proposed regulations did not include cash as property not subject to the consistent basis requirement and described cash that is not subject to the reporting requirement fairly generically. Prop. Reg. §1.6035-1(b)(1). The final regulations add more guidance for cash-type assets that are not subject to the consistent basis or reporting requirements. The following are not subject to either the consistent basis or reporting requirements: U.S. dollars (defined to include physical bills and coins with values equal to their face values, Reg. §1.1014-10(d)(6)), U.S. dollar-denominated demand deposits, certificates of deposit denominated in U.S. dollars, cash collateral denominated in U.S. dollars held by a third party to secure a liability, money market funds, life insurance proceeds payable in a lump sum in U.S. dollars, and tax refunds (Federal, state, or local) payable in U.S. dollars. Reg. §1014-10(c)(2); §1.6035-1(f)(2).

The preamble to the final regulations lists as examples the following items that do not fall within the list of excepted property in § 1.6035– 1(f)(2) of the final regulations:

> (1) currency other than in United States dollars; (2) any payments not made in United States dollars; (3) life insurance policies not paid in United States dollars, and life insurance policies payable to a beneficiary in United States dollars annually or at some other interval for a period of time after the decedent's death; (4) notes (other than an installment obligation subject to section 453) that the decedent did not forgive in full upon the decedent's death, whether or not expressed in United States dollars; (5) U.S. Savings bonds; and (6) accounts receivable (unless such property consists entirely of the right to receive an item of income in respect of a decedent as defined in section 691 (IRD)). This property generally has basis, its value generally may not equal its face value and, accordingly, this property is not excepted from the reporting requirements in the final regulations. For the same reasons, digital assets as defined in section 6045(g)(3)(D), including virtual currency or cryptocurrency, do not fall within the list of excepted property set forth in § 1.6035–1(f)(2) of the final regulations.

Preamble to Final Regulations, T.D. 9991, 89 FED. REG. 76356, at 76368 (Sept. 17, 2024).

(f) **Household and Personal Effects.** In the exception for "tangible personal property for which an appraisal is not required under §20.2031-6(b)," the final regulations changes "tangible personal property" to "household and personal effects" to conform more closely to §20.2031-6(b).This refers to household and personal effects that do not have a marked artistic or intrinsic value over $3,000.

(g) **Notes Forgiven by Decedent.** The final regulations add as an exception to the consistent basis and reporting requirements notes that are forgiven in full by the decedent, whether or not denominated in U.S. dollars. Reg. §1014-10(c)(2)(viii); §1.6035-1(f)(2)(viii).

(h) **Property Whose Basis is Unrelated to the Federal Estate Tax Value of the Property.** The proposed regulations except income in respect of decedent property from the consistent basis and reporting requirements. The final regulations add to the consistent basis and reporting exceptions several other types of assets whose basis is unrelated to the estate tax value of the property:

- Annuity contracts subject to §72 and amounts received as an annuity under §72;
- Income in respect of a decedent property described in §691;
- Amounts received under installment obligations subject to the §453 installment method;

- Stock of a passive foreign investment company (§1296(i)) if the basis is the decedent's basis immediately before death;
- Retirement plans, deferred compensation plans and IRAs expressed entirely in U.S. dollars;
- Bonds to the extent redeemed by the issuer for U.S. dollars prior to being distributed to a beneficiary;
- Property included in the gross estate of a beneficiary who died before the due date of the Information Report (the Form 8971); and
- Any other property that may subsequently be identified by the IRS as excepted property.

Reg. §1.1014-10(c)(2)(x); §§1.6035-1(f)(2)(xi).

(i) **Property Sold or Disposed of in Recognition Events.** Assets sold or disposed of in recognition events (whether or not resulting in gain or loss and whether any gain is capital or ordinary) are not subject to the reporting requirements under §6035. The final regulations add examples of such property.

> In addition, in response to requests for additional clarification, §1.6035-1(f)(2)(x)(A) through (E) of the final regulations include examples of excepted property pursuant to this rule as follows: (1) property distributed in satisfaction of a pecuniary bequest on which the estate recognizes any gain or loss pursuant to §1.661(a)-2(f); (2) property for which an election under section 643(e)(3) has been made for the estate to recognize any gain or loss; (3) interests in business entities that are redeemed for United States dollars prior to distribution to a beneficiary; (4) property disposed of in a transaction described in section 267(a) and (b)(13), which disallows a loss from the sale or exchange of property, directly or indirectly, between the executor and the beneficiary of the estate, except in a sale or exchange in satisfaction of a pecuniary bequest; and (5) property subject to the mark to market accounting method at the time of distribution from the estate or from the decedent's revocable trust.

Preamble to Final Regulations, T.D. 9991, 89 FED. REG. 76356, at 76369-70 (Sept. 17, 2024).

(8) **Information Returns and Supplemental information Returns.** The final regulations add various clarifications regarding information to be reported on initial and supplemental Information Returns (Form 8971), including the situations for which supplemental Information Returns must be filed.

One of the clarifications is that an Information Return must be filed even if all distributions from the estate are of property excepted from the reporting requirements. If excepted property exists, the executor must disclose on the Information Return that some or all of the property included in the gross estate is excepted from the full reporting requirements, but the executor is not required to identify the excepted property or provide a Statement to a beneficiary with regard to excepted property. Reg. §1.6035-1(f)(1).

Several clarifications are made regarding reporting to beneficiary trusts. The beneficiary Statement is generally given to the trustee of the trust, but the final regulations allow the executor to furnish the Statement directly to trust beneficiaries, with a copy to the trustee, "if the executor reasonably believes that it is unlikely that the beneficiary trust will depreciate, sell, or otherwise dispose of the property subject to reporting in a recognition event for income tax purposes but instead will distribute the property in kind to the trust beneficiaries." Reg. §1.6035-1(g)(2)(i). If a beneficiary trust does not have at least one trustee and a tax ID number by the due date for filing the Information Return, the executor "must report on the Information Return that the beneficiary trust has not yet been established." Once the beneficiary trust has been established and the trust information becomes available to the executor, a supplemental Information Return and Statement must be filed within 30 days. Reg. §1.6035-1(g)(2)(ii).

(9) **Penalties.** The regulations to §6721 (failure to file correct information returns) and §6722 (failure to furnish correct payee statements) are modified in the final regulations to clarify that those sections apply to Information Returns and Statements, respectively, under §6035 as to

Information Returns and Statements required to be filed on or after January 1, 2024. The preamble further clarifies the penalty provisions.

> A penalty applies separately to each initial or supplemental Information Return that the executor is required to file with the IRS, and to each initial or supplemental Statement that the executor is required to furnish to a beneficiary. Accordingly, only one penalty under section 6721 may be imposed for filing an incorrect Information Return, even if copies of multiple required Statements are not attached to the Information Return, but multiple penalties under section 6722 may be imposed for furnishing multiple incorrect Statements, even if the Statements were filed with the IRS as attachments to a single Information Return.

Preamble to Final Regulations, T.D. 9991, 89 FED. REG. 76356, at 76372 (Sept. 17, 2024). The final regulations also refer to §6724 and applicable regulations relating to waivers of the penalties if it is shown that the failure was due to reasonable cause and not to willful neglect. Reg. §1.6035-1(i).

(10) **Property Subject to Debt.** The final regulations keep the helpful provision that the value of property for basis purposes is the gross value undiminished by recourse or non-recourse debt, regardless of whether the estate tax return reports the net value or separately reports the gross value and the outstanding debt. Reg. §1.1014-10(b)(3)(i).

(11) **Effective Date of Regulations.** Consistent with §7805(b)(1), the §1.1014-10 consistent basis final regulations apply to estates of decedents if the estate tax return is filed after the date of publication in the Federal Register, and the §1.6035-1 reporting final regulations apply to estates required to file an estate tax return if the return is filed after the date of publication in the Federal Register (i.e., after September 17, 2024). Reg. §1.1014-10(f); §1.6035-1(j). However, the consistent basis and reporting requirements in general continue to apply to estates for which estate tax returns are filed after July 31, 2015.

c. **Basis of Grantor Trust Assets at Death Under §1014 (Number 2); Rev. Rul. 2023-2.** The Priority Guidance Plans 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 and Estates and Trusts issues on the 2022-2023 Plan. It apparently is the IRS's response to political pressure (see Item 4.c(3) below).

Beginning in 2015, the IRS no-ruling list has included 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. 2024-3, 5.01(10).

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

(4) **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.*, Mitchell Gans & Jonathan Blattmachr, *Grantor Trust Assets and Section 1014: New Ruling Doesn't Solve the Problem*, 139 J. TAX'N 16 (Sept. 2023); Jonathan Blattmachr, Mitchell Gans & Hugh 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).

(5) **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 in a dialogue with Representative Bill Pascrell (D-NJ) 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.

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

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

The complete holding of the Ruling is:

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

revenue ruling's facts, the basis of Asset immediately after A's death is the same as the basis of Asset immediately prior to A's death.

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

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

(8) **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 §1014(a) is to be in one of the categories listed in §1014(b), and it reasoned that none of the sub-sections in §1014(b) applies. 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).

(9) **Does Not Apply to Sale to Grantor Trust Situation Where Note Is Outstanding at Death.** The fact that the holding in the Ruling applies just to assets given to the trust (the ruling said it addresses an asset transferred to the trust in a transaction that was "a completed gift for gift tax purposes") and the existence of the second caveat in the facts of the Ruling (i.e., the liabilities of the trust do not exceed basis and no notes exist between the parties at the grantor's death) suggest that the Ruling does not apply to the classic sale to grantor trust situation (at least as to the assets sold to the trust) if a note from the trust is unpaid at the grantor's death. **The ruling does not address the issue that is most concerning to planners regarding basis issues and grantor trusts.** In that respect, this revenue ruling might be referred to as "revenue ruling lite."

(10) **Purchase of Assets by Grantor Before Death; Note Purchase.** One way to achieve a basis adjustment for assets in a grantor trust that is not includable in the grantor's gross estate is for the grantor to purchase the appreciated assets from the grantor trust for cash before the grantor's death. The appreciated assets would be owned by the grantor at death and clearly get a basis adjustment under §1014. There would be no additional estate tax attributable to the appreciated assets because the grantor's estate would have been depleted by an equal amount cash paid in the purchase transaction.

What if the grantor pays for the assets with a note? Carlyn McCaffrey points out that the trust's basis in the note when the grantor dies is unclear. For income tax purposes, the note does not exist until the grantor's death, and at death it has neither an adjusted basis under §1014 nor a cost basis under §1012. The basis might be zero, which would be a terrible result because all payments from the grantor's estate to the trust might be ordinary income.

A possible planning alternative is for the estate to distribute the note to a testamentary trust for descendants, and sometime later (after the estate audit is completed), the trust that holds the note (i.e., the prior grantor trust) could decant the note to the same testamentary trust for descendants, which would make the note disappear under merger principles because the same person who is obligated to pay also holds the note.

Carlyn suggests that the safer approach would be for the grantor to borrow funds from a third party to purchase the assets from the grantor trust while the trust is still a grantor trust, then turn off the grantor trust status, and then borrow funds from the then nongrantor trust to repay the third party before the grantor's death.

(11) **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 were 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 were 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.

(12) **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.i of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (February 2024) 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 5 below.

e. **Portability Regulatory Election Extensions Increased from Two to Five Years, Rev. Proc. 2022-32 (Number 4 of 2022-2023 Priority Guidance Plan).** 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). 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 29.d of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (September 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

f. **Alternate Valuation Period (Number 4).** 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.** These final regulations are among the next projects that will completed in the gifts and estates area, but their issuance is not imminent.

g. **Section 2053 Proposed Regulations (Number 5).** 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 regulations and planning implications are discussed in Item 6 below.

h. **Qualified Domestic Trust Elections (Number 6).** The IRS released proposed regulations on August 20, 2024, which were published in the Federal Register on August 21, 2024, updating various outdated references regarding qualified domestic trusts (QDOTs). No substantive changes to the rules for QDOTs are included.

i. **GST Exemption Allocation (Numbers 8).** Number 8 first appeared in the 2021-2022 Plan, but it is related to the final regulations regarding §2642(g) (Number 8 on the 2023-2024 Plan and deleted in the 2024-2025 Plan), 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 2024) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

Proposed regulations regarding §2642(g) were published on April 17, 2008 (REG-147775-06). Now, sixteen years later, final regulations have been issued. Reg. §26.2642-7, §301.9100-2(f), §301.9100-3(g). The final regulations (RIN 1545-BH63) were approved March 12, 2024, were released on May 3, 2024, and were published on May 6, 2024 (89 Fed. Reg. 37116-37127). A variety of changes (mostly rather minor) have been made between the proposed and final regulations. Some of the major changes are briefly summarized below.

(3) **Section 2642(g)(1) Added in 2001.** The Economic Growth and Tax Relief Reconciliation Act of 2001(the "2001 Tax Act") added subsection (g)(1) to §2642, directing Treasury to publish regulations regarding circumstances in which extensions would be granted (1) to allocate GST exemption, (2) to elect out of automatic allocations of GST exemption to lifetime direct skips under §2632(b)(3) or to elect out of lifetime allocations to "GST trusts" under §2632(c)(5)(B)(i), or (3) to treat a trust as a GST trust as to any or all transfers made by such individual to such trust pursuant to §2632(c)(5)(A)(ii).

Before the addition of §2642(g)(1) in the 2001 Tax Act, such extensions of time were not available under Reg. §301.9100-3 ("9100 relief") because the deadlines for those actions were prescribed by the Code, not by regulations. Shortly after the enactment of the 2001 Tax Act, Notice 2001-50 stated that taxpayers could seek extensions in those situations using 9100 relief. In addition, Rev. Proc. 2004-46, provides a simplified method for dealing with pre-2001 annual exclusion gifts that did not meet the special "vesting" requirements in §2642(c)(2).

(4) **New Procedures Under Reg. §26.2642-7 Must be Used in Lieu of "9100 Relief."** The procedures under Reg. §26.2642-7 now must be used to obtain such extensions (including the automatic six-month extension under Reg. §301.9100-2(b), *see* Reg. §26.2642-7(i)(1)), and 9100 relief is no longer available for extensions regarding GST exemption allocations or elections. Reg. §301.9100-2(f) & §301.9100-3(g). Notice 2001-50 is obsolete. Cathy Hughes, Treasury Office of

Tax Legislative Counsel, explained at the American Bar Association Tax Section 2024 Spring Meeting why the new procedures were needed. She explained that the procedures for 9100 relief

> don't mesh well or apply well in the contest of the GST tax…. The purpose of this whole project was to tailor the standards for relief to the GST tax, which differs in many significant ways from income taxes.

Brett Ferguson & Chandra Wallace, *After 16 Years, Treasury Finalizes Rules for GSTT Extensions*, TAX NOTES FEDERAL 1267 (May 13, 2024) (hereinafter "Treasury Finalizes Rules").

The regulations apply to requests for relief made on or after May 6, 2024. Pending extension requests filed before that date will continue to be processed under the 9100 relief provisions unless the taxpayer opts to withdraw the prior request and refile for relief under the new regulations.

Extension requests under the new regulations will be administered under the procedures for obtaining IRS letter rulings. Reg. §26.2642-7(i)(2). Cathy Hughes anticipates that the user fees applicable for 9100 relief will also apply to extension requests under Reg. §26.2642-7. *See* Treasury Finalizes Rules. User fees are discussed further in Item 4.i(10) below.

(5) **Simplified Procedures.** The simplified procedures under Rev. Proc. 2004-46 for certain pre-2001 annual exclusion gifts may still be used, and the IRS may in the future consider other situations in which simplified relief may be made available.

(6) **Additional Proposed Regulations Coming.** The preamble to the final regulations explains that additional proposed regulations will be forthcoming to address the practical effect of a grant of an extension of time for making elections and the interplay between affirmative and automatic allocations. *See* Reg. §26.2642-7(b)(2) & §26.2642-7(f) ("[Reserved]" sections). The upcoming proposed regulations will include examples applicable to this new regulation and the newly proposed regulations. (These forthcoming proposed regulations apparently are related to Item 7 of the "Gifts Estates and Trusts" section of the 2023-2024 Priority Guidance Plan.)

(7) **Provisions Regarding Basis for Determination.** The proposed and final regulations list various factors that are considered in determining whether relief will be granted. That depends on whether evidence is produced (including affidavits, as discussed below) establishing to the IRS's satisfaction that the transferor "acted reasonably and in good faith and that the grant of relief will not prejudice the interest of the government." Reg. §26.2642-7(d)(1). The IRS will consider the nonexclusive lists of factors contained in the regulations as well as other factors relevant to the particular situation. *Id*.

(a) **Reasonableness and Good Faith.** The final regulations add a paragraph making clear that this is a facts and circumstances test, and "as a general rule, no single factor (whether listed or not) will be determinative in all cases." All the listed factors may not be relevant in a particular situation. While no particular factor is necessarily determinative, evidence relating to a single factor may be sufficient in a particular situation to persuade the IRS to grant extension relief. Reg. §26.2642-7(d)(2). Factors described in the proposed regulations (and continued in the final regulations with minor revisions) include (i) intent of the transferor, (ii) intervening events, (iii) lack of awareness ("despite the exercise of reasonable diligence" as added by the final regulations) of the need to allocate GST exemption, (iv) consistency of the transferor including a pattern of electing (although the final regulations add that relief "will not be denied merely because a pattern of allocation or election does not exist or because the existing pattern changed at some point"), and (v) reasonable reliance on a qualified tax professional.

(b) **Prejudice to the Interests of the Government.** The proposed regulations describe a nonexclusive list of factors that are continued in the final regulations with some clarifications. An important factor emphasized in the regulations is that "[a]n attempt to benefit from hindsight will be deemed to prejudice the interests of the government." The final regulations add an example of when the use of hindsight will constitute prejudice:

> Prejudice also would exist if the transferor failed to make the allocation or election in order to wait to see (thus, with the benefit of hindsight) whether making an allocation of exemption or election would be more beneficial than not making the allocation or election. For instance, assume that a transferor funds several trusts with different property interests on the same date, and does not allocate GST exemption to any trust. Several years later, the transferor seeks relief to allocate GST exemption to the trust that enjoyed the greatest asset appreciation and thus constitutes the most effective use of the transferor's GST exemption. Relief will not be granted because the transferor attempted to benefit from hindsight and thereby acquire an economic advantage.

Reg. §26.2642-7(d)(3)(i). The hindsight factor is reiterated in a later section of the regulations and the "greatest appreciation" situation was repeated:

> Relief under this section will not be granted if the IRS determines that the requested relief is an attempt to benefit from hindsight by waiting to see which of multiple transfers, made at substantially the same time but consisting of different property interests, enjoyed the greatest appreciation and thus would constitute the most effective use of the transferor's GST exemption.

Reg. §26.2642-7(e)(5).

Other factors related to prejudice to the interests of the government include timing of the requested relief and intervening taxable events. The final regulations also add a paragraph addressing closed years stating that, subject to the considerations in the "timing of requested relief" section, the expiration of limitations of the assessment or collection of transfer taxes generally is not relevant to whether relief will be granted, but if the value reported on a gift or estate tax return likely constituted a gross valuation misstatement, the purported undervaluation will be considered as to whether the relief would prejudice the interests of the government.

(8) **Relief From Affirmative Elections Is Permitted Under Final Regulations.** The proposed regulations provided that relief would not be granted from affirmative elections (1) to elect out of automatic allocations of GST exemption to lifetime direct skips under §2632(b)(3), (2) to elect out of lifetime allocations to "GST trusts" under §2632(c)(5)(B)(i), or (3) to treat a trust as a GST trust as to any or all transfers made by such individual to such trust pursuant to §2632(c)(5)(A)(ii). The preamble to the final regulations acknowledges, though, that no statute "provides that an election made under section 2632(b)(3) or (c)(5) is irrevocable." Therefore, the final regulations delete the statement in the proposed regulations that relief is not available to revoke an election under §2032(b)(3) or (c)(5) made on a timely filed gift or estate tax return.

(9) **Relief From Affirmative Allocations of GST Exemption.** Section 2631(b) provides that an allocation of GST exemption under §2631(a), once made, is irrevocable. The final regulations make clear that relief generally will not be granted to revoke an affirmative allocation (as opposed to an automatic allocation) of GST exemption, for both lifetime allocations and allocations upon a transferor's death. Reg. §26.2642-7(e)(2)(i). However, the final regulations add three exceptions to the general rule (and the first two exceptions are automatic – no request for relief is required).

(a) **Excess Exemption Allocation.** Exemption allocation is **void** to the extent it exceeds the amount necessary to result in a zero inclusion ratio, but this exception does not apply to charitable lead annuity trusts or trusts subject to an estate tax inclusion period (such as a GRAT). Reg. §26.2642-7(e)(2)(ii)(A).

(b) **No GST Potential.** Exemption allocation is **void** for a transfer to a trust that, at the time of the allocation, has no GST potential with respect to the transferor making the allocation. For purpose of this exception, a trust has GST potential even if the possibility of a GST is so remote as to be negligible. Reg. §26.2642-7(e)(2)(ii)(B).

(c) **Late Allocations Made When Extensions Not Available Prior to Enactment of §2642(g).** The preamble to the final regulations summarize this third exception, for which relief is not automatic but must be requested, as follows.

> The third exception is that a late allocation (as defined in section 2642(b)(3)) will be deemed to be void as part of the relief granted under section 2642(g) if the late allocation was made in an effort to mitigate the tax consequences of the missed allocation that is the subject of the grant of relief and that was not

eligible for relief prior to the enactment of section 2642(g)(1). Specifically, such a late allocation is deemed to be void if (1) prior to December 31, 2000, a transfer was made to a trust with GST potential with respect to the transferor; (2) a timely allocation of GST exemption to the trust was not made; (3) prior to December 31, 2000, a late allocation of GST exemption was made to the trust; (4) the late allocation is disclosed as part of the request for relief or during the IRS's consideration of that request; and (5) relief under section 2642(g)(1) is granted to make a timely allocation to the transfer made prior to December 31, 2000.

(10) **Affidavits.** The final regulations continue the requirements in proposed regulations (with modifications) that affidavits be supplied from advisors connected with the GST exemption allocation or election decision. The proposed and final regulations list four categories of persons who must provide affidavits: (a) agents or legal representatives of the transferor who participated in certain activities, (b) preparers of gift or estate tax returns, (c) each individual (including employees of the transferor) who participated in certain activities, and (d) tax professionals who participated in certain activities. In particular, the final regulations narrow the list of persons who must provide affidavits. For example, the proposed regulations required affidavits from each tax professional who was consulted by the transferor or executor of the transferor's estate about "**any aspect of the transfer, the trust,** the allocation of GST exemption, and/or the election under section 2632(b)(3) or (c)(5)." (Emphasis added). That could include any number of advisors over decades who may have given advice about some aspect of the trust, having nothing to do with GST exemption allocations or elections. The final regulations narrow the list of tax professionals who must give affidavits by omitting the words "any aspect of the transfer, the trust."

(11) **Ability to Revoke GST Exemption Allocation to a Trust Subject to an Estate Tax Inclusion Period (ETIP)?** The preamble to the final regulations says: "The allocation of exemption to a trust subject to an ETIP does not become irrevocable until the termination of an ETIP." There is no similar provision in the substantive provisions of the new regulations. A pre-existing regulation states the opposite. Reg. §26.2632-1(c)(1)(ii) ("An affirmative allocation of GST exemption cannot be revoked, but becomes effective as of (and no earlier than) the date of the close of the ETIP with respect to the trust"). Section 2642(f)(1) provides that an allocation of GST exemption to property involving an ETIP cannot be made before the end of the ETIP, which suggests that an affirmative allocation to a trust subject to an ETIP could be modified or revoked prior to the close of the ETIP.

(12) **User Fee.** The user for obtaining letter rulings is generally $38,000 (except for taxpayers with gross income less than $1 million), but the user fee for "9100 relief" is only $12,600. Notice 2001-50. Which will apply going forward for GST rulings? The preamble to the final regulations says "[t]he user fee would follow the same schedule and amount as rulings under §301.9100-1." Hopefully, the IRS will follow through with a revenue procedure making that clear.

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 but has appeared on subsequent plans (see Item 9 on the 2023-2024 Plan). Informal statements from Treasury officials indicate this project may be issued soon. Planners are concerned about the possible effective date of the regulations and whether they will be applied retroactively to require the filing of returns for gifts and bequests made by expatriates since 2008 when §2801 was passed. For a discussion of this issue, see Item 29.i of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (September 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

k. **New Actuarial Tables Under §7520 (Number 11 of 2022-2023 Priority Guidance Plan).** The actuarial tables project, added in the 2019-2020 Plan, is to update the §7520 actuarial tables based on updated mortality information, which must be done every ten years and was last done effective May 1, 2009. Proposed regulations were published on May 5, 2022 (more than three years after the statutorily required date of May 1, 2019), and final regulations were released on June 1, 2023.

The proposed regulations provided transition rules, and the major change in the final regulations addressed those transition rules. Although the new tables were supposed to be finished by May

2019, the proposed regulations allowed transition relief only back to January 1, 2021. The final regulations extend transition relief to May 2019. For gifts or estates of decedents dying on or after May 1, 2019, and on or before June 1, 2023, the donor or executor may choose to value the interest (including any applicable charitable deduction) based on either Table 2000CM or Table 2010CM. The donor or executor "must consistently use the same mortality basis with respect to each interest in the same property."

For further discussion of this project see Item 8 of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and Item 5.j of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (February 2024) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

l. **Donor Advised Fund Proposed Regulations.** The Pension Protection Act of 2006 enacted various special rules for donor advised funds (DAFs) to guard against perceived abuses. The statute added excise taxes regarding (1) transaction with and benefits received by donors and donor-advisors and (2) distributions from DAFs. Some of the new statutory provisions are §4958 (25% excise tax on excess benefit transactions, including compensation payments to a donor or advisor appointed by a donor), §4966 (20% excise tax on each "taxable distribution" from a DAF), and §4967 (125% excise tax on transactions providing more than an incidental benefit to the donor or the donor's family).

After issuing several Notices providing interim guidance, the IRS finally (seventeen years later!) issued proposed regulations addressing some of the issues regarding these rules. Prop. Reg. §§53.4966-1 through -6, REG-142338-07, 88 Fed. Reg. 77922-77941. The proposed regulations generally provide guidance with expansive definitions of a donor advised fund, donor advisor, taxable distribution, sponsoring organization, fund manager, and disqualified supporting organization and giving guidance about what distributions are "taxable distributions" and guidance about excise taxes on taxable distributions. Some of the topics addressed include guidance as to when a donor may serve on an advisory committee without being treated as having "advisor privileges" and regarding the compensation of advisors.

In what perhaps is the most controversial provision, the IRS proposes that compensation from a DAF to an investment advisor who advises the donor regarding the DAF and also provides investment advice to the donor on personal investments would be an "excess benefit" subject to a 25% excise tax under §4958 unless the advisor provides investment advice to the supporting organization of the DAF as a whole. *See* Jonathan Curry, *Estate Planner Takes Issue With 'Surprising' Proposed DAF Regs*, 182 TAX NOTES Federal 554 (Jan. 15, 2024) (summarizing comments of Carlyn McCaffrey at the 2024 Heckerling Institute). This provision has been widely criticized. Leaders of community trusts and community foundations report that some potential donors are shying away from DAFs because of this provision; "donors may open private foundations instead of DAFs to retain their personal investment advisers." Schilling, *Charities Ask for Rare Do-Over on IRS Donor-Advised Fund Rules*, BLOOMBERG DAILY TAX REPORT (May 9, 2024) (reporting testimony from Deborah Wilkerson, president and CEO of the Greater Kansas City Community Foundation at hearing with IRS officials about the proposed regulations).

The effective date provision raises concerns; the effective date is the tax year in which the regulations become final. This means the regulations will apply retroactively to transactions that occur during the taxable year the final regulations are issued including before the issuance date. (For example, investment management fees paid to "donor advisors" during that taxable year before the issuance date would be subject to the 25% excise tax, and the compensation would have to be returned to the sponsoring organization.)

m. **Proposed Regulation Treating The Use of Certain Abusive Charitable Remainder Annuity Trusts as a Listed Transaction.** This is part of the project of issuing proposed regulations regarding various "listed transactions" in light of the Tax Court's holding in *Green Valley Investors, LLC v. Commissioner*, 159 T.C. 80 (2022) (Reviewed by the Court) that prior Notices describing listed transactions did not comply with the Administrative Procedure Act. The Eleventh Circuit has ruled similarly. *Green Rock, LLC v. Internal Revenue Service et al*, 133 AFTR 2d 2024-1630 (11th Cir. June 4, 2024) (issuance of Notice 2017-10 labeling certain syndicated conservation easement deals as

listed transactions was in violation of the APA; ruling does not address validity of listed transaction designations other than Notice 2017-10), *acq*. AOD 2024-10, 2024-52 IRB 1354. See Item 21.c of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. (Final regulations were released October 7, 2024, (TD 10007, RIN 1545-BQ39) treating conservation easements as listed transactions.)Proposed regulations were released March 22, 2024 (scheduled to be published in the Federal Register on March 25, 2024), identifying as a listed transaction the use of abusive charitable remainder annuity trusts that purchase a single premium immediate annuity (SPIA) to permanently avoid recognition of ordinary income and/or capital gain. Prop. Reg. §1.6011-15. The beneficiary would treat "the annuity amount payable from the trust as if it were, in whole or in part, an annuity subject to section 72, instead of carrying out to the beneficiary amounts in the ordinary income and capital gain tiers of the trust in accordance with section 664(b)." REG-108761-22, preamble at 13-14

n. **Post-AJCA Reportable and Listed Transaction Notices Will Not Be Enforced.** The American Jobs Creation Act of 2004 (AJCA) added and amended various Code sections providing penalties for failing to disclose "reportable transactions" and a sub-category of reportable transactions called "listed transactions," as described in Reg. §1.6011-4. The IRS has issued various Notices identifying certain transactions as listed and other reportable transactions. The Tax Court, Sixth Circuit, and Eleventh Circuit have all held that Notices identifying particular transactions as reportable or listed transactions did not comply with the notice-and-comment rulemaking procedures under the Administrative Procedure Act. *Green Rock LLC v. Internal Revenue Serv.*, 104 F.4th 220 (11th Cir. 2024); *Mann Construction, Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022); *Green Valley Investors, LLC v. Commissioner*, 159 T.C. 80 (2022). *Green Rock LLC* reasoned that statutory penalties imposed under the AJCA revisions are what render a listing notice as a legislative rule subject to notice-and-comment rulemaking procedures.

   The IRS issued an acquiescence in *Green Rock LLC*. AOD 2024-01, 2024-52 IRB 1354. The acquiescence states that the IRS will not enforce disclosure and reporting requirements and will not assert penalties regarding post-AJCA reportable transactions identified in Notices that did not comply with notice-and-comment procedures.

   > Despite our disagreement with the Eleventh Circuit's ruling, we recognize that there is controlling adverse precedent in both the Sixth Circuit and the Eleventh Circuit, as well as in the Tax Court. The reasoning of this precedent applies to all existing post-AJCA listing notices, which are not distinguishable with respect to the application of notice-and-comment rulemaking procedures. The Sixth Circuit, Eleventh Circuit, and Tax Court have all held that the post-AJCA notices create new substantive duties, the violations of which can lead to financial penalties and criminal sanctions. The Eleventh Circuit explicitly noted that 28 of the 34 existing listed transactions, issued pre-AJCA, were not backed by statutory penalties at the time of their issuance, and held that "penalties and criminal sanctions" are what render a listing notice a "legislative" rule subject to notice-and-comment rulemaking procedures. *Green Rock*, 104 F.4th at 229. Therefore, the reasoning of this adverse precedent applies to all existing post-AJCA reportable transaction notices.
   >
   > The Service will follow the Sixth and Eleventh Circuit and the Tax Court decisions in all circuits and will no longer defend post-AJCA reportable transaction notices.… The Service will not take these steps in cases where there is a court-approved settlement or closing agreement relating to the aforementioned penalties, there is an existing final court decision, or the applicable statutes of limitations have expired. This AOD does not apply to pre-AJCA notices.

   AOD 2024-01, 2024-52 IRB 1354.

o. **Foreign Trusts and Foreign Gifts to U.S. Persons.** Extensive proposed regulations (153 pages) were released on May 7, 2024 ,dealing with foreign trusts and foreign gifts. REG-124850-08. The proposed regulations revise the standards for U.S. taxpayers to report large foreign gifts and transactions with foreign trusts (including loans and distributions from and the use of property of foreign trusts). For a brief overview of the proposed regulations, see Andrew Velarde, *Detailed Foreign Trust, Gift Regs Address Reporting Penalties*, TAX NOTES (May 8, 2024).

p. **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-MA, and Sheldon Whitehouse, D-RI) and Senators Chris

Van Hollen, D-MD, and Bernard Sanders, I-VT) details what they view as a "blatant abuse of our tax system," and requests Treasury to take *regulatory* steps to remove many of the transfer planning advantages of GRATs and grantor trusts. *See* Alan Gassman, *Bernie Sanders and Elizabeth Warren Win a Battle in the War on the Taxation of Grantor Trusts*, FORBES (April 5, 2023). This request for current *regulatory* action is in the face of unsuccessful legislative attempts over multiple years to address some of the advantages of GRATs and grantor trusts. Indeed, the 2023 and 2024 FY Greenbooks again make various legislative proposals to take away some of the transfer planning opportunities of GRATs and grantor trusts, as discussed in Item 3.a(3) above and Item 3.a(4) 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 urges that Treasury has the authority and should take various steps administratively to cut back on what it views as abusive wealth shifting opportunities: (1) revoke Rev. Rul. 85-13; (2) revoke Rev. Rul. 2004-64; (3) require GRATs to have a minimum remainder value (for example, 25% of contributed assets); (4) reissue the §2704(b) proposed regulations; (5) confirm Chief Counsel Advice 200937028 (the IRS did this by issuing Rev. Rul. 2023-2 regarding the basis of assets in a grantor trust if the trust is not included in the grantor's gross estate); and (6) adopt more restrictions for GRATs (minimum and maximum permitted terms, treat swaps as prohibited additional contributions, and limitations on valuation of transferred remainder interests). For a more detailed discussion of the recommendations in that letter, see Item 5.m of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

q. **Inflation Adjustments.** Inflation adjustments using the C-CPI-U numbers published by the Bureau of Labor Statistics and based on information through August 31 (typically available in mid-September of each year) for 2021, 2022, 2023, 2024, and 2025 were announced in Rev. Proc. 2020-45, Rev. Proc. 2021-45, Rev. Proc. 2022-38, Rev. Proc. 2023-34, and Rev. Proc. 2024-40 respectively. Some of the adjusted amounts are as follows:

- Basic exclusion amount and GST exemption – $13,990,000 in 2025, $13,610,000 in 2024, $12,920,000 in 2023, $12,060,000 in 2022, $11,700,000 in 2021;
- Gift tax annual exclusion – $19,000 in 2025, $18,000 in 2024, $17,000 in 2023, $16,000 in 2022, $15,000 in 2018-2021 (observe that the annual exclusion was $15,000 for four years [2018-2021], but it has increased by $1,000 in each of 2022-2025;
- Estates and trusts taxable income for top (37%) income tax bracket – $15,650 in 2025, $15,200 in 2024, $14,450 in 2023, $13,450 in 2022, $13,050 in 2021;
- Top income tax bracket for individuals – $751,600/$626,350 (married filing jointly/single) in 2025, $731,200/$609,350 in 2024, $693,750/$578,125 in 2023, $647,850/$539,900 in 2022, $628,300/$523,600 in 2021;
- Taxable income threshold for §199A qualified business income – $394,600/$197,300 (married filing jointly/single) in 2025, $383,900/$191,950 in 2024, $364,200/$182,100 in 2023, $340,100/$170,050 in 2022, $329,800/$164,900 in 2021;
- Standard deduction – $30,000/$15,000 (married filing jointly/single) in 2025, $29,200/$14,600 in 2024, $27,700/$13,850 in 2023, $25,900/$12,950 in 2022, $25,100/$12,550 in 2021;
- Non-citizen spouse annual gift tax exclusion – $190,000 in 2025, $185,000 in 2024, $175,000 in 2023, $164,000 in 2022, $159,000 in 2021;
- Section 6166 "two percent amount" – $1,900,000 in 2025, $1,850,000 in 2024, $1,750,000 in 2023, $1,640,000 in 2022, $1,590,000 in 2021; and

- Special use valuation reduction limitation – $1,420,000 in 2025, $1,390,000 in 2024, $1,310,000 in 2023, $1,230,000 in 2022, $1,190,000 in 2021.

The increase of the basic exclusion amount to almost $14 million in 2025 suggests that if the estate and gift exclusion amount decreases from $10 million (indexed) to $5 million (indexed) in 2026, it would be some amount over $7 million in 2026.

r. **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 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 4.o above. The project could be revived (hopefully with revisions) under some future administration. (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* (September 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**)

s. **End of OIRA Review of Tax Regulations.** A memorandum of agreement signed June 9, 2023, between Treasury and the Office of Management and Budget provides that regulations issued by the IRS will no longer be subject to review by the Office of Information and Regulatory Affairs (OIRA). The OIRA has generally had up to 45 days to review tax regulations, but that review will no longer occur, which could save some (generally small) time in the process of issuing tax regulations. For a history of the review of tax regulations by the OIRA, see Marie Sapirie, *News Analysis: A Finale for OIRA Tax Review*, 180 TAX NOTES FEDERAL 349 (July 17, 2023).

t. **IRS Tweaking Estate and Gift Tax Returns for e-Filing.** The IRS will be making some changes to estate and gift tax returns in the next year or two as it plans for allowing e-filing of estate and gift tax returns. This is part of IRS's goal to go paperless by 2025. Some estate tax returns span thousands of pages and are shipped in boxes to the IRS. "The bevy of exhibits and attachments that often accompanies estate and gift tax returns makes the transition from paper to electronic filing of those returns a challenge." Attachments often have "unstructured data" that is not easily converted to a digital format. *See* Jonathan Curry, *ABA Section of Taxation Meeting: E-Filing Could Prompt Tweaks to Estate and Gift Tax Returns*, 182 TAX NOTES FEDERAL 961 (Jan. 29, 2024).

u. **Legal Effect of Proposed Regulations.** This item mentions various proposed regulations that have been issued in response to items that have appeared on Priority Guidance Plans. Bear in mind that proposed regulations do not become effective until final regulations are issued, and typically they take effect as to transactions occurring after that time. (On rare occasions, proposed regulations state they will apply, once the regulations are finalized, as to transactions after the date the proposed regulations are released. The anti-abuse proposed regulation regarding the anti-clawback rule takes that approach, as described in Item 5.e below.) While planners may be concerned about provisions in proposed regulations, bear in mind that "proposed regulations, … unlike final regulations, absolutely don't have the force of law. Thus, taxpayers can't be penalized in any way for failing to follow them …." Redd, *What Basis Consistency Regulations?*, TRUSTS & ESTATES 8, at 10 (May 2022). The article by Clary Redd cites very interesting comments in several cases about proposed regulations:

> *Zinniel v. Commissioner*, 883 F.2d 1350 (7th Cir. 1989), *aff'g* 89 T.C. 357, at 369 (proposed regulations "carry no more weight than a position advanced on brief" (quoting *F.W. Woolworth Co. v. Comm'r*, 54 T.C. 1233, 1265 (1970)); *see also LeCroy Research Sys. Corp. v. Comm'r*, 751 F.2d 123, 127 (2d Cir. 1984) ("Proposed regulations are suggestions made for comment; they modify nothing.")

Id. at n.15.

7. 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.

b. **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 $7 million), the $12 million is added into the estate tax calculation as an adjusted table gift, but the estate exclusion amount is only $7 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 $7 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 $7 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.**

c. **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.

d. **Examples.** Examples of transfers includible in the gross estate, gifts of promissory notes, gifts subject to §2701, gifts to a GRAT, gifts of DSUE amounts, and deathbed planning alternatives, as well as comments by the New York State Bar Association Tax Section to the proposed regulations are discussed in Item 6 of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

e. **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.

f. **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).

8. 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 4.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." The first two are briefly summarized below. For a more detailed discussion of those two and for a summary of the last two, see Item 7 of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

b. **Applying Present Value Concepts to §2053 Deductions.** 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).

   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." Observe that while most administration expenses of most estates are paid within three years of death, that is not necessarily typical for taxable estates (the ones for which the administration expense is important), especially taxable estates that undergo an estate tax examination.

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.

   (3) **Interest on Unpaid Tax and Penalties.** Post-death interest on unpaid tax and penalties will generally be deductible, with some limitations. See Item 7.c(1) of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

   (4) **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 VII.D of Akers, Modern Estate *Administration—New (As Well as Old) Issues Arising After Death,* 58TH ANNUAL HECKERLING INST. ON EST. PL. (2024) (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). Those factors (none of which by themselves are presumably determinative) are:

(1) reasonableness of the interest rate and loan terms,

(2) executor enters the loan arrangement,

(3) lender reports interest income (including OID if interest payments are not made annually),

(4) loan is used to satisfy liabilities essential to proper settlement of the estate,

(5) payment schedule corresponds to ability to make payments and is not extended unreasonably,

(6) loan is necessary to avoid below-market sale of assets or forced liquidation of a business "or some similar financially undesirable course of action,"

(7) illiquidity (including that the estate does not have control of an entity with liquid assets sufficient to satisfy the estate's liabilities or to compel the entity to sell liquid assets) and the estate will have cash flow or liquidity to make loan payments,

(8) illiquidity does not result from the testamentary estate plan,

(9) lender is not a substantial beneficiary,

(10) lender is not a beneficiary whose share of the liability is the same as her share of the estate, and

(11) the estate cannot recover estate tax from the lender. Prop. Reg. §20.2053-3(d)(2).

Factors that are particularly important, and that may be problematic for estates in particular situations are:

(1) the interest rate and loan terms (including any prepayment penalties) are reasonable and comparable to arm's-length transactions;

(2) the lender includes the interest in gross income for income tax purposes, especially if the lender is a family member, related entity, or beneficiary;

(3) the payment schedule corresponds to the estate's ability to make payments and is not extended beyond what is reasonably necessary;

(4) 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";

(5) 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); on the other hand, various cases (all cited below) have refused to second guess the business judgment of the executor about retaining an appropriate level of liquid assets, *Estate of Murphy, Jr. v. U.S.*,

McKee v. Commissioner, *Estate of Thompson v. Commissioner*, *Estate of Duncan v. Commissioner*, *Estate of Sturgis v. Commissioner*];

(6) 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;

(7) the lender is not a substantial beneficiary or entity over which the beneficiary has control, particularly troublesome is if the lender's share of the estate's liability is the same as the beneficiary's share of the estate; and

(8) the estate has no right to recover estate tax from the person loaning the funds.

The "self-created illiquidity" issue is concerning because many clients, especially business owners, could have done things differently in their financial planning that would have created more liquidity (although may have resulted in less wealth creation). Will that be enough to deny an interest deduction when the estate needs to borrow funds to pay estate tax or other obligations? That sounds very close to the issue of "second-guessing business judgment" decisions that various courts have refused to engage in. Tabetha Peavey of the Treasury Office of Tax Legislative Counsel reported at the ABA Tax Section Meeting in January 2024, that the §2053 proposed regulations are "trying to distinguish between estates that are facing genuine illiquidity and estates that are manufacturing illiquidity." *See* Jonathan Curry, *ABA Section of Taxation Meeting: Guidance Banning 'Hoffman' CRATs is Imminent*, 182 TAX NOTES FEDERAL 948 (Jan. 29, 2024).

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 court refused to deny the deduction because an FLP did not sell assets and make a large distribution to the estate, 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 derived from the proposed regulations is that 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.

For a discussion of various cases regarding the deductibility of interest (*Black*, *Duncan*, *Keller*, *Beat*, *Thompson*, and *McKee*) see Item 7.c(2)-(3) of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

d. **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/legislative-comments/actec-submits-comments-regarding-proposed-regulations-under-code-section-2053/**.

e. **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).

9. Trust Modification to Add Power to Reimburse Grantor of Grantor Trust for Income Tax (Which Results in Gifts by Trust Beneficiaries Who Consent), CCA 202352018

a. **CCA 202352018 – Facts and Synopsis of Ruling That Consent by Beneficiaries to Trust Modification (Adding a Trustee Power to Reimburse the Grantor for Income Taxes Attributable to Grantor Trust Income) Results in Gift by Beneficiaries.** CCA 202352018 concludes that the modification of an irrevocable grantor trust with beneficiaries' consent, to add a tax reimbursement clause providing the trustee with a discretionary power to make distributions of income or principal in an amount sufficient to reimburse the grantor for income tax attributable to inclusion of the trust's income in grantor's taxable income, would constitute a taxable gift by the beneficiaries of a portion of their respective interest in income and/or principal of the trust. Prior to the modification, neither State law nor the governing instrument of the trust required or provided such reimbursement authority. The CCA specifically states that the result would have been the same if the beneficiaries had not explicitly consented, but if they had notice of the modification and a right to object but failed to exercise their right to object.

The CCA distinguished Rev. Rul. 2004-64, which holds that if the original governing instrument (rather than a modification with the beneficiaries' consent) provided for a mandatory or discretionary right to reimbursement for the grantor's payment of the income tax, such payment to the grantor would not constitute a gift by the trust beneficiaries. The CCA distinguished a reimbursement provision in the original trust agreement vs. the addition of a reimbursement provision in a modification action.

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

c. **How to Value the Gift.** The CCA does not address how to value the gift and acknowledges that "the determination of the values of the gifts requires complex calculations" (without addressing how to approach making such complex calculations). Footnote 2 simply states that "Child and Child's issue cannot escape gift tax on the basis that the value of the gift is difficult to calculate."

The CCA, in its statement of the law, summarizes several regulations relevant to the valuation issue as follows:

> Section 25.2511-1(e) provides that if a donor transfers by gift less than their entire interest in property, the gift tax is applicable to the interest transferred. Further, if the donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the *entire value* of the property subject to the gift.
>
> …
>
> Section 25.2511-2(a) provides that the gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer. Rather, it is a tax upon the donor's act of making the transfer. The measure of the gift is the *value of the interest passing from the donor* with respect to which they have relinquished their rights without full and adequate consideration in money or money's worth. (Emphasis added)

(3) **Entire Value?** The IRS did not expand on the citation of Reg. §25.2511-1(e) suggesting that the gift could be the "entire value" of the trust (which would be an outrageous result). *See* Ronald Aucutt, *Reimbursement of Grantor for Income Tax Paid on a Grantor Trust's Income*, ACTEC CAPITAL LETTER NO. 61 (Jan. 19, 2024) , available **here** ("In any event, taxing the beneficiaries on the entire value of the trust property in the case of this CCA is an outcome that seems simply too extreme to be entertained, even under the surprising aggressiveness of this CCA"). The Capital Letter also addresses reasons why §2702 should not be applicable to result in a gift of the entire value of the trust.

(4) **Repeated Annual Reimbursement Unlikely.** Even if reimbursement of the grantor for paying income tax on the trust's income is permitted, the settlor likely will not seek and the trustee likely will not routinely reimburse the settlor in every year. A mandatory reimbursement right in the original trust agreement would have caused inclusion of the trust assets in the grantor's gross estate under §2036(a)(1). Rev. Rul. 2004-64 (Situation 2). A discretionary reimbursement right in the original trust could also result in estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement. Rev. Rul. 2004-64 (Situation 3). A settlor could argue that a subsequent modification of the trust to add a reimbursement right might not cause §2036 to apply because nothing was "retained" by the settlor at the time of the transfer to the trust, but routine reimbursement of the settlor would at least raise the significant possibility that all the trust assets would be included in the settlor's gross estate. The settlor and trustee both likely would want to avoid that result.

(5) **Factors Affecting Valuation.** Many factors (some of which might be very uncertain) would affect the valuation of any such gift including the size of the trust, anticipated income of the trust in future respective years, anticipated income tax of the grantor in each of those years that might be reimbursed, the likelihood that the grantor would ask the trustee to consider reimbursing the grantor in each of those years, the likelihood that the trustee would actually reimburse the grantor for some or all of the tax in any of those years, the age and life expectancy of the grantor, the likelihood that any such reimbursement would reduce the amount that would be distributed to any particular beneficiary from the trust, and the number of current and potential future beneficiaries of the trust. Some of these factors are so speculative that some planners question whether appraisers could be located that would even attempt to place a value on any such gift. *See* Paul Hood & Ed Morrow, *CCA 202352018: The Trustee's Discretionary Power to Reimburse a Settlor/Grantor for the Income Tax Paid on the Trust's Income*, Leimberg Estate Planning Newsletter #3098 (Feb. 5, 2024) ("We doubt seriously that many qualified professional appraisers are going to want to wade into this valuation exercise, especially given that many of these engagements are probably going to cost much more to appraise than the value of the alleged gift.")

To avoid an argument that adding a discretionary reimbursement power could authorize reimbursement of **prior** income tax payments (which could be quantified more readily), the modification should limit the discretionary reimbursement power to future income tax of the grantor to prevent a retroactive reimbursement distribution. *Id*. ("We fear that absent such limitation, neither the trustee nor the IRS would be limited in the amount of the reimbursement to settlor/grantor of the inclusion (up to the total date of death value of the trust) by the IRS.")

(6) **Allocation of Gift Amount Among Multiple Beneficiaries.** Another difficult valuation issue is that the amount of any gift by each particular beneficiary would have to be determined. The CCA explicitly refers to gifts by "Child and Child's issue" in footnote 2, acknowledging that gifts would be made by multiple beneficiaries who have differing interests.

d. **Possibly No Reduction of Benefits for Beneficiaries.** One can imagine a situation in which the beneficiaries actually benefit from the modification. For example, the grantor may decide to take steps to relinquish rights or powers that cause the trust to be a grantor trust if the trust is not modified to give the trustee the discretion to consider reimbursing the grantor in some situations.

In certain situations (for example, with very large trusts), the likelihood that a trustee would make reimbursement payments or that making reimbursement payments to the grantor would reduce the amount of any discretionary distributions to any current beneficiaries may be infinitesimally small. Theoretically, gifts might be made by remote descendants who would eventually receive the trust assets outright at the trust termination (which could be hundreds of years in the future), but how can unborn persons make gifts (even if some attorney representing the unborn descendants consents to the modification)? At what point would any such theoretical gift, by reason of consenting to the modification, be incomplete? *See generally* Diana Zeydel, *When Is a Gift to a Trust Complete: Did CCA 201208026 Get It Right?,* 117 J. TAX'N 3 (September 2012); Diana Zeydel, *Developing Law on*

Changing Irrevocable Trusts: Staying Out of the Danger Zone, 47 REAL PROP. TR. & EST. L.J. 1 (Spring 2012) (discussing tax effects of trust modification, rescission, reformation, or decanting transactions).

e. **Existing Authority For Failure to Enforce Rights as a Gift.** Authority exists for treating the failure to enforce one's legal rights as a gift by that individual in appropriate circumstances. *See* Rev. Rul 84-105 (surviving spouse's failure to object to underfunding of a general power of appointment marital deduction trust); Rev. Rul 81-264 (failure to enforce note payable). Also, consenting to trust modifications in appropriate circumstances can result in a gift. *See* Reg. §26.2601-1(b)(4)(i)(E) Ex.7 ("modification increasing A's share of trust income is a transfer by B and C to A for Federal gift tax purposes").

Even so, treating the consent to judicial modification to add a trustee discretionary reimbursement power as a gift seems inappropriate in this situation. Rev. Rul. 2004-64 confirms that the grantor's payment of income tax on grantor trust income is not a gift to trust beneficiaries. It would seem rather ironic to treat the return of that benefit to the grantor, in whole or in part, as a transfer for gift tax purposes.

> Rev. Rul. 2004-64 confirmed that the grantor's payment of income tax on the income of a grantor trust is not a gift by the grantor to the trust's beneficiaries because it is paid in discharge of the grantor's own liability, imposed by section 671. In other words, when the trust was created as a grantor trust, the grantor gave the beneficiaries the value transferred to the trust, which was a taxable gift, and also gave the beneficiaries a framework within which the grantor would in effect pay the future income tax on *their* income, but *that* was *not* a taxable gift. If the benefit of the arrangement to pay that income tax is not a transfer to the beneficiaries for gift tax purposes, how, it might be asked, can what amounts to the return of that benefit to the grantor, in whole or in part, be a transfer for gift tax purposes?

Ronald Aucutt, *Reimbursement of Grantor for Income Tax Paid on a Grantor Trust's Income*, ACTEC CAPITAL LETTER NO. 61 (Jan. 19, 2024), available **here**.

f. **Application to Decanting Transactions.** Decanting transactions are probably much more common than trust modification transactions. Will beneficiaries in all decanting transactions have to be concerned about gift implications? Under some state laws, beneficiaries' consent may be required, but under many state laws beneficiary consent is not required, though a beneficiary could sue the trustee for breach of trust regarding the changes made in any particular decanting transaction. The CCA explicitly stated that "[t]he result would be the same if the modification was pursuant to a state statute that provides beneficiaries with a right to notice and a right to object to the modification and a beneficiary fails to exercise their right to object."

g. **Moving Trust Situs?** What if, instead of modifying the trust to add a reimbursement power, the trustee resigned and whoever had the power to appoint a successor trustee appointed a trustee in a state (such as Florida or New Hampshire) that by statute automatically gives the trustee a reimbursement power? *See* Jennifer Smith & Kristen Curatolo, *Grantor Trust Reimbursement Statutes*, TRUSTS & ESTATES 25-30 (Feb. 2021). The result would be the same but without requiring the beneficiary's consent.

h. **Reporting Transaction on Gift Tax Return.** Perhaps beneficiaries will consider filing gift returns and reporting the modification transaction as a non-gift transaction or placing an estimated value (probably very nominal) on the amount of the gift. If adequate disclosure is made, that will start the running of the three-year period of assessments (but it also may be viewed as raising a red flag to the IRS attention as to whether the modification has gift, estate, or GST tax effects).

i. **Trust Transferor for Other Purposes?** If the beneficiaries are treated as making a gift to the trust, various complexities would arise for Income, GST, and estate tax purposes as a result of the beneficiaries becoming partial transferors of the trust. Those complexities would not arise, however, under the reasoning of the CCA because it treats the trust modification as a transfer by the beneficiaries "for the benefit of [the grantor of the trust]," rather than as a transfer to the trust.

j. **Trend to Increased Focus on Gifts Effects of Modifications or "Failure to Object" Transactions?** CCA 202352018 has caused consternation among many planners who wonder if it hints at a new focus by the IRS on "failure to object" or consent transactions. *See* Paul Hood & Ed Morrow, *CCA*

202352018: The Trustee's Discretionary Power to Reimburse a Settlor/Grantor for the Income Tax Paid on the Trust's Income, Leimberg Estate Planning Newsletter #3098 (Feb. 5, 2024) ("While such valuation difficulties don't prevent the existence of a gift, we strongly suspect that both the valuation difficulty and the likely very small taxable gift that might result will effectively preclude the IRS from employing its limited resources in cases like these to the most low-hanging fruit. We submit that the IRS may be using this occasion to rethink other more substantial trust modifications that might more clearly involve a true transfer of wealth.")

Interestingly, many PLRS have been issued regarding tax effects of trust modification transactions, and many (if not most) of them do not even address gift tax issues (and the IRS obviously did not require that gift issues be considered in those requests.) For example, PLR 202206008 ruled on a settlement modifying a trust to grant a testamentary formula general power of appointment to the settlor's sole surviving child to appoint asset to the child's estate. The PLR ruled that (1) the modification would not impact the GST-tax-exempt status of the trust, and (2) only the property subject to the child's general power of appointment would be included in the child's gross estate under §2041(a)(2). No mention was made of a gift by trust beneficiaries even though the effect was to eliminate the vested rights that remainder beneficiaries had before the trust was modified. PLR 202206008 is discussed in Item 19.a of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

Would the IRS react differently now in light of CCA 202352018 to a settlement that grants a general power of appointment to a trust beneficiary?

Transfers in compromise and settlement of a trust or estate dispute typically will be treated as transfers for full and adequate consideration that do not result in gifts. The IRS has issued a number of favorable private letter rulings finding no gift tax exposure in a variety of settlement contexts. *E.g.*, PLR 201342001, 201104001, 200845028, 200825007, 200638020, and 200209008. Planners often worry about the gift issue in settlement discussions, but tax litigators traditionally have advised "this is one of the scariest things that almost never happens."

k. **Remember What a CCA Is.** A Chief Counsel Advice is not a published ruling by the IRS or even an informal statement of the IRS's position about an issue generally. A Chief Counsel Advice typically arises in a specific examination that may be headed to litigation. It may be requested by the examiner for direction regarding positions to take in that specific examination, but more important, to encourage a settlement by the taxpayer, who would know that his or her position is rejected by the national office of the IRS Chief Counsel.

> A Chief Counsel Advice typically arises from a specific audit or audits of a specific case or cases that are probably headed to litigation if they are not settled. For that reason, it is always possible that there is a backstory, not revealed in the CCA itself, that would explain the IRS's seemingly aggressive reaction. It is also reasonable to assume that a CCA is written to support the strongest possible litigation position, either to reinforce the litigation itself or to encourage the taxpayer to avoid litigation by agreeing to a settlement that is favorable to the IRS, which in this case might be an agreed higher value for the beneficiaries' purported gifts.

Ronald Aucutt, *Reimbursement of Grantor for Income Tax Paid on a Grantor Trust's Income*, ACTEC CAPITAL LETTER NO. 61 (Jan. 19, 2024), available **here**.

10. Corporate Transparency Act Overview

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

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

their applicants and owners will be created. FinCEN estimates that 32,556,929 entities will submit reports in 2024, and in subsequent years it estimates that about five million reports will be filed each year. At a hearing before the House Financial Services Committee on July 9, 2024, Secretary Yellen said that about 2.7 million businesses had filed to date (of the 32.6 million that are required to file by the end of 2024). FinCEN reported that in September, 4.5 million beneficial reports had been filed, and the weekly filing rate has nearly doubled since the spring.

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. 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.** A 50-page guide from FinCEN, titled "Small Entity Compliance Guide" (Version 1.1, dated December 2023), is available from the FinCEN webpage, **https://www.fincen.gov/news/news-releases/fincen-issues-compliance-guide-help-small-businesses-report-beneficial-ownership**. A 59-page Beneficial Ownership Information Reporting Frequently Asked Questions document, updated October 3, 2024, is available on the FinCEN website at **https://www.fincen.gov/sites/default/files/shared/BOI-FAQs-QA-508C.pdf**.

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

(1) There is no upper limit on the number of beneficial owners;

(2) There should be at least one beneficial owner for every entity (even if no individual has 25% or more of the ownership interests, at least one person should have "substantial control");

(3) Entities that have always been exempt are not required to report to claim their exempt status (speakers did not explain how to deal with the fact that a new entity created after 2024 must report within 30 days, and the entity will likely not have its exempt letter within 30 days after being created);

(4) Company "Applicant" information, which must be provided for entities created after 2023, needs to be updated only if it was wrong, not just because information about the Applicant changes; and

(5) Speakers did not provide specific guidance about what a Reporting Company should do if Beneficial Owners refuse to provide their information.

(6) **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 highly regulated companies, such as banks and investment companies under the Investment Company Act of 1940 are also exempt. In all, 23 exceptions exist, one of which is for companies that employ more than 20 people, have gross receipts exceeding $5 million from domestic sources, and have a physical operating presence in the U.S. (The entity must have filed a federal income tax return for the previous year demonstrating $5 million in gross receipts or sales. Thus, the large company exempt category will not be available in the first year of the company's existence because it will not have filed a return in the prior year.) **Most of the corporations, limited partnerships, and LLCs that estate planning professionals create for their clients will NOT be exempt**.

Updated FAQs from FinCEN, dated July 8, 2024, clarify the application of the CTA to dissolved entities. An entity that ceased to exist as a legal entity before January 1, 2024, is not a reporting company that must file ownership reports. However, if the entity "did not entirely complete the

process of formally and irrevocably dissolving before January 1, 2024," it is required to report even if the company had wound up its affairs and ceased conducting business before January 1, 2024. Similarly, an entity formed after January 1, 2024, must be reported even if it ceased to exist before its initial beneficial ownership report was due. FinCEN, *Beneficial Ownership Information Frequently Asked Questions*, C.13-14 (Updated July 8, 2024).

An updated FAQ dated July 24, 2024, clarifies that a single member LLC that is a "disregarded entity" for tax purposes will not be required to obtain its own EIN, but can report the Tax ID number of the single member (F.13).

An updated FAQ dated October 3, 2024, addresses community property ownership and control, concluding that "[i]f, applying community property State law, both spouses own or control at least 25 percent of the ownership interests of a reporting company, then both spouses should be reported to FinCEN as beneficial owners unless an exception applies." (D.18). The October 3, 2024 also addresses unauthorized practice of la issues; nothing in the CTA or regulations prevents a service provider who is not an attorney from submitting ownership reports to FinCEN, but "[w]hether an action qualifies as the unauthorized practice of law, however, is generally determined by state law, and thus may vary." (B.9)

(7) **Beneficial Owners, Particular Issues for Trusts.** 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. Each entity must have at least one Beneficial Owner. An individual "exercises substantial control" if the individual has (i) a senior officer position, (ii) appointment/removal powers over any senior officers, (iii) direction or substantial influence over important matters, or (iv) any other form of substantial control.

If a trust exercises substantial control or owns at least 25% of the Reporting Company, the regulations generally treat as Beneficial Owners (i) a trustee "or other individual (if any) with the authority to dispose of trust assets," (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 (observe, this would include spouse-beneficiaries of QTIP trusts), 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 provisions in the regulations regarding trusts leave uncertainty about who might be included as having "authority to dispose of trust assets." Would that include –

- investment advisors or distribution advisors for directed trusts,
- someone who holds a power of appointment,
- someone who holds a veto power over distributions,
- a grantor or even a third party with a swap power,
- a person holding a Crummey withdrawal power over a specific amount, or
- anyone else who has the legal right to move the trust's interest in the Reporting Company out of the trust?

Proposed regulation §1010.380(d)(3)(ii) referred to individuals directly or indirectly owning or controlling an ownership interest of a reporting company "through a variety of means, including **but not limited to**" [emphasis added] several listed items, including the statement about trusts in §1010.380(d)(3)(ii)(C). The ACTEC Comments to FinCEN dated February 4, 2022 (available **here**), about the proposed regulations pointed out many ambiguities and that the "'including but not limited to' language may lead to confusion."

The final regulation changed this language (in §1010.380(d)(2)(ii)) to refer to individuals directly or indirectly owning or controlling an ownership interest of a reporting company "through any contract, arrangement, understanding, relationship, or otherwise, including" the same listed items. Does the elimination of "but not limited to" suggest that the listed items are the exclusive

list of ways persons connected with a trust can be a Beneficial Owner? The regulations do not say the list is an exclusive list. Indeed, the preamble to the final regulations indicates that "those are specific examples of the more general principle" that "trust arrangements can vary significantly in form, so the examples in the final rule do not address all applications of the general principle." A footnote in the preamble observed that commenters had asked if trust protectors and advisors were included and asked how the regulation applied if "decisions concerning distributions were made by a committee." FinCEN, on April 18, 2024, updated its Beneficial Ownership Information Frequently Asked Questions. Question D.15 summarizes the individuals (i.e., a trustee or other individual with the authority to dispose of trust assets, a beneficiary in certain situations, or a settlor in certain situations) listed in the final regulations who may own or control ownership interests through a trust, but the answer makes clear that is not an exclusive list:

> This may not be an exhaustive list of the conditions under which an individual owns or controls ownership interests in a reporting company through a trust. Because facts and circumstances vary, there may be other arrangements under which individuals associated with a trust may be beneficial owners of any reporting company in which that trust holds interests.

Earlier in that same answer, FinCEN made clear beneficial ownership through a trust is a facts and circumstances test.

> Trust arrangements vary. Particular facts and circumstances determine whether specific trustees, beneficiaries, grantors, settlors, and other individuals with roles in a particular trust are beneficial owners of a reporting company whose ownership interests are held through that trust.

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? The ACTEC Comments noted this uncertainty:

> But how is this provision to be applied when an entity is serving as trustee? Would the reporting company be required to determine what individuals (such as employees) within that entity might fit within this provision? If so, what if no single individual has the authority to act on behalf of the entity serving as trustee (such as when, as an example, material distributions are only made by a committee)?

FinCEN's updated Beneficial Ownership Information Frequently Asked Questions (dated April 18, 2024) include new questions and updated information about reporting companies, beneficial ownership through trusts (specifically, in Questions D.13 to D.15), and access to beneficial ownership information, among other topics. Question D.15 addresses how a corporate trustee is reported as a beneficial owner, but the answer seems rather confused. It refers repeatedly to individuals who indirectly own or control at least 25 percent of the ownership interests of the reporting company through their "ownership interests in the corporate trustee" (which would not be relevant for most institutional corporate trustee situations), but it also refers to "individuals employed or engaged by" the corporate trustee who exercise substantial control over a reporting company. The answer provides little practical guidance as to which individuals involved with a corporate trustee would be reported as beneficial owners.

Updated FAQs added on October 3, 2024, address community property issues (both spouses must be reported as beneficial owners, D.18) and whether a non-attorney who submits BOI information to FinCEN engages in the unauthorized practice of law (nothing in the CTA or regulations prohibits a non-attorney from submitting reports; "[w]hether an action qualifies as the unauthorized practice of law, however, is generally determined by State law, and thus may vary," B.9).

For an excellent summary of issues arising for trusts, see Stephen Liss, *Trusts and the Corporate Transparency Act: Harder Than it Looks*, TRUSTS & ESTATES 12-16 (January 2024).

(8) **Applicants.** "Applicants" (who create a company) must also be reported. The final regulations clarify that 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. Applicants can list a business street address (contrasted with Beneficial Owners, who must list a current residential address).

(9) **Beneficial Ownership Information Reports.** "Beneficial Ownership Information Reports" (sometimes referred to as "BOI Reports") must be filed by Reporting Companies. The Reporting Company must identify itself (full legal name, any trade name or doing business as 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 from an acceptable identification document (passport, state identification document, or driver's license), the name of the issuing jurisdiction, and an image of the document. If an individual provides the four pieces of information to FinCEN directly, the individual may obtain a "FinCEN Identifier," which can then be provided to FinCEN in a Beneficial Information Report in lieu of the required information about the individual. (Attorneys who form a substantial number of reporting entities may wish to obtain a FinCEN Identifier.)

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

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

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

FinCEN on August 14, 2023, filed a proposed deadline extension, titled "Beneficial Ownership Information Reporting Deadline Extension for Reporting Companies Created or Registered in 2024" with the Office of Information and Regulatory Affairs proposing that the deadline for filing beneficial ownership reports be extended beyond the current 30-day due date after an entity is formed in 2024. The formal proposal was filed September 27, 2023, proposing to extend the deadline from 30 days to 90 days for companies created in 2024 (RIN 1506-AB62). The preamble to the proposed extension states that the extension to 90 days will give companies more time to understand the new reporting obligations (FinCEN will be publishing additional informational materials), more time to obtain the information needed to complete the reports, and more time to resolve questions that may arise in the process of completing their reports. The January 1, 2025, due date for entities created before January 1, 2024, would not be affected. The reporting deadline extension was finalized with the release of its revised rule on November 29, 2023, (RIN 1506-AB62).

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

Rep. Joyce Beatty (D-OH) and Rep. Zach Nunn (R-IA) on August 2, 2023, introduced H.R. 5119, the "Protect Small Business and Prevent Illicit Financial Activity Act," which would, among other things, extend the due date for filing reports by entities created before 2024 to January 1, 2026 (rather than January 1, 2025) and extend the time for filing reports for companies created in 2024 or later to 90 days (rather than 30 days) after the creation of the entity. This is the first bipartisan bill to extend the filing deadlines. It would also bar Reporting Companies from responding "unknown" or "unable to identify" (or similar responses) in beneficial ownership reports, which the sponsors believe would close a loophole that would otherwise allow criminals to avoid the reporting requirements. H.R. 5119 passed the House on December 12, 2023, by a vote of 420-1. Rep. Nunn filed a bipartisan bill (H.R. 9278) on August 2, 2024, to delay the reporting deadline by one year.

In a hearing before the House Financial Services Committee on July 9, 2024, Treasury Secretary Yellen dismissed calls to extend the reporting deadline from January 1, 2025 to the beginning of 2026, saying: "It's not a difficult process. We have seen a good response so far, and I don't think it's necessary to extend the time frame." *See* Rifaat, *Republicans and Yellen Clash Over Corporate Transparency Act*, 184 TAX NOTES FEDERAL 563 (July 15, 2024). At the hearing, Secretary Yellen said that about 2.7 million businesses had filed to date, but Rep. Norman (R-SC) pointed out "that's kind of a low percentage" of the 32.6 million businesses that are estimated to need to file by the end of 2024. FinCEN has reported that the filings in 2024 had increased to 4.5 million in September.

The text of a continuing resolution to extend government funding at fiscal 2024 levels until March 14, 2025, was released by Congressional leaders on December 17, 2024. It included Section 122 that would have extended the filing date for companies created before January 1, 2024 to January 1, 2026. The final version of the continuing resolution that was enacted on December 21, 2024 did not include that provision.

(11) **Penalties.** Willful failure to file a timely required report or willfully providing false information with FinCEN may result in civil penalties of $500/day the report is outstanding and criminal fines up to $10,000 and up to two years imprisonment. 31 USC §5336(h)(3)(A).

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

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

b. **Access to Beneficial Ownership Information; Additional Guidance.** FinCEN issued proposed regulations on December 15, 2022, governing the disclosure, access, and safeguarding of beneficial ownership information (referred to as BOI). Those final rules were released December 21, 2023 (RIN 1545-AB59). A Fact Sheet summarizing those final rules is available on the FinCEN website at **https://fincen.gov/news/news-releases/fact-sheet-beneficial-ownership-information-access-and-safeguards-final-rule**.

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

c. **Constitutionality of CTA.** *National Small Business United, d/b/a the National Small Business Association v. Yellen*, Case No. 5-22-cv-1448-LCD (N.D. Ala. March 1, 2024). The district court held that the Corporate Transparency Act is unconstitutional "[b]ecause the CTA exceeds the Constitution's limits on the legislative branch and lacks a sufficient nexus to any enumerated power to be a necessary or proper means of achieving Congress' policy goals …" The court examines three sources proposed by the government to support the constitutional authority for Congress' enactment of the CTA: (1) the foreign affairs power, (2) the Commerce Clause authority, and (3) Congress' taxing power. The bulk of the opinion analyzes the Commerce Clause, and the focus of the analysis is on the distinction between regulating the mere formation of entities versus the regulation of entities that actually move in foreign or interstate commerce. The court expressed the view that "Congress would have written the CTA to pass constitutional muster … [by] imposing the CTA's disclosure requirements on State entities as soon as they engaged in commerce, or … prohibiting the use of interstate commerce to launder money, 'evade taxes, hide … illicit wealth, and defraud employees and customers.'" The court did not address the plaintiff's allegations that the CTA violates the First, Fourth, Fifth, Ninth, and Tenth Amendments.

FinCEN issued a notice on March 4, 2024, that it will continue to implement the CTA generally but will not enforce the Act against specific plaintiffs in the case including members of the National Small Business Association as of March 1, 2024.

The case is on appeal to the Eleventh Circuit Court of Appeals. A number of amicus briefs were filed with the Eleventh Circuit, arguing both for and against the CTA's constitutionality. In response to a case decided by the Supreme Court in July 2024, addressing facial challenges to statutes on constitutional grounds (*Moody v. NetChoice LLC*, 144 S. Ct. 2383 (2024)), the Eleventh Circuit requested the parties to submit supplemental briefs arguing whether the district court erred "in not holding the plaintiffs to their burden of showing that there are no constitutional applications of the Corporate Transparency Act." Oral arguments before the Eleventh Circuit were heard on September 27, 2024. For a summary of issues raised in the oral arguments, see Nana Sarfo, *Eleventh Circuit Weighs the Corporate Transparency Act,* 185 TAX NOTES FEDERAL 206 (Oct. 14, 2024).A number of other cases have been filed in federal courts challenging the constitutionality of the CTA. *E.g.*, *Boyle v. Yellen*, No.24-00081 (D. Maine March 15, 2024) (business owner seeking injunctive relief from CTA for himself); *Small Business Association of Michigan et al v. Yellen et al*, No. 1:24-cv-00314 (W.D. Mich. Mar. 26, 2024); *Gargasz v. Yellen*, No. 23-cv-02468 (N.D. Ohio) (arguing invalidity of CTA and its regulations under the Constitution, the Paperwork Reduction Act, and the Administrative Procedure Act and seeking nationwide injunction); *Firestone v. Yellen*, No. 3:24-cv-1034-SI (D. Ore.); *Taylor v. Yellen*, No. 2:24-cv-00527 (D.C. Utah July 29, 2024) (Fourth Amendment, Due Process, Congress exceeded authority; right to associate); *Texas Top Cop Shop v. Garland*, No. 4:24-cv-478 (E.D. Texas May 28, 2024) (restriction on First Amendment rights and invasion of private papers and effects protected by the Fourth Amendment; seeks nationwide injunctive relief); *Black Economic Council of Massachusetts, Inc. v. Yellen*, No. 1:24-cv-11411 (D. Mass. May 29, 2024) (Fourth Amendments rights of beneficial owners and applicants; outside of enumerated powers; First Amendment right to associate; Fifth and Ninth Amendment claims; seeks nationwide injunctive relief).

Several federal district courts have refused to impose a preliminary injunction on the enforcement of the CTA.

A federal district court in Michigan denied a preliminary injunction against enforcement of the CTA on April 26, 2024. No opinion was posted but a Case Management Order simply stated that the plaintiff's motion for preliminary injunction was denied "[f]or the reasons stated on the record during oral argument." *Small Business Association of Michigan v. Yellen*, No. 1:24-cv-314 (W.D. Mich.).

A federal district court in Oregon on September 20, 2024, refused to grant a preliminary injunction against the enforcement of the CTA, finding that the plaintiffs failed to demonstrate a likelihood of success on the merits (that the Act is unconstitutional), irreparable injury, or that the balance of hardships tipped in their favor. *Firestone v. Yellen*, No. 3:24-cv-1034-SI (D. Ore. September 20, 2024). The court addressed claims that the Act exceeded Congress's constitutional authority and claims of

unconstitutionality under the First, Fourth, Fifth, Eight, Ninth, and Tenth Amendments, and that the statute is unconstitutionally vague.

A preliminary injunction was also denied on October 24, 2024, by a Michigan federal district court in Virginia. The court concluded that the plaintiffs were unlikely prevail in contesting the constitutionality of the CTA under the Commerce Clause and under the Frist Amendment or that the FinCEN rules implementing the CTA failed to comply with the Administrative Procedure Act's notice-and-comment requirements. *Comm'ty Assocs. Inst. v. Yellen* , No. 24-cv-1597 (E.D. Va., October 24, 2024) .

Disclosure provisions in the Bank Secrecy Act were held to be constitutional in *California Bankers Ass'n v. Shultz*, 416 U.S. 21 (1974). S*ee also United States v. Miller*, 425 U.S. 435 (1976).

d. **Nationwide Preliminary Injunction Against CTA and Its Implementing Regulations, *Texas Top Cop Shop, Inc. v. Garland*.** The federal district court in the Eastern District of Texas on February 3, 2024, granted the plaintiffs' motion for a preliminary injunction from enforcing the Corporate Transparency Act and its implementing regulations, and the court did so with a *nationwide* injunction. *Texas Top Cop Shop, Inc. v. Garland*, No. 4: 24-CV-478 (E.D. Texas December 3, 2024). The court determined that the plaintiffs carried their motion to prove:

> (1) that the CTA and Reporting Rule substantially threaten Plaintiffs with irreparable harm; (2) a substantial likelihood of success on the merits of any of their challenges; (3) that the threatened harm outweighs any damage the injunction might have on the Government; and (4) that preliminary injunctive relief will not harm the public.

As to the threat of irreparable harm, the court refused to set a bright line rule in the context of this case as to what a de minimis harm to the Plaintiffs would be, observing that "deprivations of constitutional rights come a few dollars at a time" and that FinCEN acknowledges that companies throughout the country will incur substantial compliance costs in complying with the CTA. Perhaps more importantly, once the plaintiffs "must comply with an unconstitutional law, the bell has been rung"; they would have disclosed information they seek to keep private and surrendered to a law they contend exceeds Congress's powers. "That damage 'cannot be undone by monetary relief.'"

As to the likelihood of success, the plaintiffs had alleged that the CTA is beyond Congress's constitutional powers and violates their rights under the First, Fourth, Ninth, and Tenth Amendments. The court concluded that the CTA is beyond Congress's enumerated powers, is not justified by the Commerce Clause or the Necessary and Proper Clause, and the plaintiffs showed a substantial likelihood of success. (The court did not address the claims under the First and Fourth Amendments.)

The court addressed the third and fourth factors with an analysis of balancing the equities and concluded that the CTA is likely unconstitutional and the court could not render a meaningful decision on the merits before the reporting deadline which would cause the plaintiffs to "suffer the very harm they seek to avoid. A preliminary injunction will preserve the constitutional status quo. Thus, the balance of equities favors the issuance of an injunction."

In addressing the scope of the preliminary injunction, the court observed that the government noted that granting a preliminary injunction against enforcement of the CTA as to the 300,000 members the National Federation of Independent Businesses (one of the plaintiffs) would effectively be a nationwide injunction. The court acknowledged the controversy regarding nationwide injunctions but concluded that a nationwide injunction is appropriate in this case.

> The Court determines that the injunction should apply nationwide. Both the CTA and the Reporting Rule apply nationwide, to "approximately 32.6 million existing reporting companies." …. NFIB's membership extends across the country. And, as the Government states, the Court cannot provide Plaintiffs with meaningful relief without, in effect, enjoining the CTA and Reporting Rule nationwide. The extent of the constitutional violation Plaintiffs have shown is best served through a nationwide injunction. *See Califano*, 442 U.S. at 705; *Career Colls. & Schs. of Tex.*, 98 F.4th at 256. Given the extent of the violation, the injunction should apply nationwide.

The government filed a Notice of Appeal (with the Fifth Circuit Court of Appeals) on December 5, 2024, and filed a Motion to Stay Preliminary Injunction Pending Appeal on December 11, 2024.

On December 17, 2024, the district court denied the government's motion to stay the injunction pending appeal, concluding that the Government does not have a "substantial case on the merits" and even if it did, "the equities here do not 'weigh heavily' in favor of granting a stay."

The effect is that no one has reporting obligations currently under the CTA. FinCEN posted a statement on December 6, 2024, acknowledging that it will comply with the court's order "for as long as it remains in effect" and that the nationwide preliminary injunction "stays all deadlines to comply with the CTA's reporting requirements."

> Therefore, reporting companies are not currently required to file their beneficial ownership information with FinCEN and will not be subject to liability if they fail to do so while the preliminary injunction remains in effect. Nevertheless, reporting companies may continue to voluntarily submit beneficial ownership information reports.

On December 23, 2024, the U.S. Court of Appeals for the Fifth Circuit granted a stay of the district court's preliminary injunction pending the outcome of the Department of the Treasury's ongoing appeal of the district court's order. The Fifth Circuit was of the view that "the government has made a strong showing that it is likely to succeed on the merits in defending CTA's constitutionality." The order expressed little sympathy for the plaintiff's position that lifting the stay days before the compliance deadline would be unduly burdensome because the reporting deadlines under the CTA have been in effect for almost a year while the injunction only in place for approximately three weeks. The order also expedited the appeal to the next available oral argument panel.

FinCEN issued an Alert on December 23 noting the stay of the nationwide preliminary injunction but agreeing to an extension of filing deadlines for various situations. Reporting companies created before 2024 have until January 13, 2025 to file their initial beneficial ownership information reports.

On December 24, 2024, the plaintiffs filed a motion for rehearing and also filed an emergency petition for an en banc hearing.

The order from the panel hearing motions was vacated on December 26, 2024, by a different panel addressing the merits of the case. The order concluded that "in order to preserve the constitutional status quo while the merits panel considers the parties' weighty substantive arguments, that part of the motions-panel order granting the Government's motion to stay the district court's preliminary injunction enjoining enforcement of the CTA and the Reporting Rule is VACATED."

FinCEN issued an Alert on December 27, 2024, noting the Fifth Circuit's action and that "the injunction issued by the district court in *Texas Top Cop Shop, Inc. v. Garland* is in effect and reporting companies are not currently required to file beneficial ownership information with FinCEN."

For a discussion of the controversy regarding nationwide injunctions under district court orders, see *District Court Reform: Nationwide Injunctions*, 137 HARV. L. REV. 1701 (2024).

d. **CPAs Request Suspension of Enforcement of BOI Reporting Until After Constitutionality Cases Are Resolved.** The AICPA, joined by all state CPA societies, sent a letter to Treasury Secretary Yellen and the FinCEN Director on April 2, 2024, asking that all enforcement of BOI reporting be suspended until one year after all court cases related to *NSBA v. Yellen* are resolved.

> We are still concerned that small businesses will be caught off guard with the new filing requirement and failure to file could result in steep civil and criminal penalties. The recent NSBA v. Yellen court case which found The Corporate Transparency Act (CTA) to be unconstitutional has only compounded confusion, with most entities believing they no longer have a filing requirement.
>
> Based on these strong concerns, we ask that you suspend all enforcement actions until one year after the conclusion of all court cases related to NSBA v. Yellen, and further believe that FinCEN should take no retroactive enforcement for non-compliance during this time. The portal can remain open, and small businesses may voluntarily report BOI, but no small business should be compelled to file, nor should any small business face enforcement for failure to comply until after the courts have worked through this complex case.

e. **Legislative Proposal; to Repeal CTA.** S.4297, the Repealing Big Brother Overreach Act, was introduced on May 9, 2024, by Sen. Tuberville (R-AL), with eleven cosponsors. Congressman Davidson (R-OH) introduced companion legislation in the House of Representatives. The bill has been endorsed by over 100 trade organizations.

f. **Residential Real Estate Non-Financed Transfers.** Real estate "all-cash" sales in certain geographic areas must currently be reported under the existing Real Estate Geographic Targeting Order program (GTO) under the Bank Secrecy Act. Regulated lenders are excluded because banks already have anti-money laundering (AML) programs and requirements of filing suspicious activity reports (SARs) under the Bank Secrecy Act.

FinCEN on February 7, 2024, filed Notice of Proposed Rulemaking (RIN: 1506-AB54) generally requiring that non-financed residential real estate transfers to trusts or entities be reported to FinCEN. Final rules were issued on August 28, 2024 (and published in the Federal Register on August 29, 2024) (RIN: 1506-AB58). FinCEN received 621 comments, and the preamble to the final rules responds to those comments. The rules are effective December 1, 2025.

(3) **Purpose.** The purpose of these reporting requirements is to combat and deter money laundering through non-financed residential real estate transfers, because non-financed transfers of residential real estate are subject to less oversight from financial institutions than financed transfers.

(4) **General Reporting Requirement.** The rules impose requirements on "Reporting Persons" (professionals involved in closing residential real estate transfers, including settlement agents, title insurance agents, escrow agents, and attorneys) to report certain information about "beneficial owners" (similar to the description of beneficial owners under the CTA) for non-financed transfers of residential real estate to a "transferee entity" (such as LLCs, corporations, or partnerships) or "transferee trust." Only one report is required for each reportable transfer, and rules provide which of the professionals would be required to file the report for particular situations.

The reporting requirement applies regardless of the size of the sales transaction (including for gift transactions) as long as the transaction is a non-financed transfer. The preamble to the final rules reasons that "[l]ow value non-financed transfers to legal entities and trusts, including gratuitous ones for no consideration, can present illicit finance risks and are therefore of interest to law enforcement." As discussed below, however, the final rules add an exception for gift transfers by an individual to a trust of which the individual is the settlor of the trust.

(5) **Attorneys as Reporting Persons.** Some commenters believed that attorneys should not be required to report primarily due to concerns about attorney-client privilege and confidentiality requirements. The final rules continue to include attorneys are possible reporting persons. FinCEN does not believe that including attorneys would cause them to violate their professional ethical obligations because the ABA Model Rules on Professional Conduct allow revealing information "to comply with other law or a court order" and annotations to the Model Rules elaborate that "[t]he required-by-law exception may be triggered by statutes, administrative agency actions, or court rules." If an attorney believes that filing a report would violate the attorney-client privilege,

> an attorney in such an unusual situation need not assume a reporting obligation, as that attorney might allow other parties in the reporting cascade to file the Real Estate Report through a designation agreement or, in certain circumstances, might decline to perform the function that triggers the obligation…. Nonetheless, FinCEN expects to issue guidance that will address the rare circumstance in which an attorney is concerned about the disclosure of potentially privileged information, which will provide further information on the mechanism for asserting the attorney-client privilege and appropriately filing the relevant Real Estate Report.

(6) **Residential Real Estate.** Residential real estate for this purpose would include "single-family homes, townhouses, condominiums, and cooperatives, including condominiums and cooperatives in large buildings containing many such units, as well as entire apartment buildings, designed for one to four families" that are located in the United States. Preamble to Final Rule. Residential real estate also includes "land located in the United States on which the transferee intends to build a structure designed principally for occupancy by one to four families."

(7) **Transferee Trusts; Beneficial Owners of Trusts.** Most types of trusts, domestic or foreign, would be included, because FinCEN believes that transfers to trusts present a high risk for

money laundering. The proposed rules specifically referred to revocable trusts. However, as discussed below, the final rules add an exception for gift transfers to certain trusts.

The definition of beneficial owners of trusts is similar to the beneficial ownership rules under the CTA. The preamble to the final rule describes beneficial owners of trusts as follows.

> the trustee; an individual other than a trustee with the authority to dispose of transferee trust assets; a beneficiary that is the sole permissible recipient of income and principal from the transferee trust or that has the right to demand a distribution of, or withdraw, substantially all of the assets from the transferee trust; a grantor or settlor who has the right to revoke the transferee trust or otherwise withdraw the assets of the transferee trust; and the beneficial owner(s) of any legal entity that holds at least one of these positions.

(8) **Exceptions (Including Gift Transfers to Certain Trusts).** Various exceptions were included in the proposed rules including certain transfers involving an easement, transfers that occur as the result of the death of the property's owner, transfers that are the result of a divorce, and transfers that are made to a bankruptcy estate. The final rules retain those exceptions, with clarifications, and adds some additional exceptions.

The transfer resulting from death exception is clarified to include a broad range of transfers occurring as a result of the death of an individual. The preamble to the final rules clarifies that

> the exception includes all transfers resulting from death, whether pursuant to the terms of a will or a trust, by operation of law, or by contractual provision. In the context of transfers resulting from death, transfers resulting by operation of law include, without limitation, transfers resulting from intestate succession, surviving joint owners, and transfer-on-death deeds, and transfers resulting from contractual provisions include, without limitation, transfers resulting from beneficiary designations. With respect to inclusion of transfers required under the terms of a trust, by operation of law, or by contractual agreements, FinCEN believes such transfers are akin to transfers required by a will, as they result from the death of the grantor or settlor or individual who currently owns the residential real property. As described in the [proposed rules], the exception was meant to include transfers governed by preexisting legal documents, such as wills, or that generally involve the court system. FinCEN believes that the adopted language will clarify the intended scope of the exception, which is meant to exclude only low-risk transfers of residential real property involving transfers that are required by legal or judicial processes at the time of the decedent's death.

The divorce transfer exception is clarified to include the dissolution of civil unions.

Exceptions are added for added for court supervised transfers and for transfers to an intermediary as part of a like-kind exchange transaction.

In response to various comments requesting exceptions for estate planning transfers, FinCEN refused to grant a broad estate planning transfer exception (for example, specifically refusing to except transfers where beneficial ownership does not change or where the transfer is an intra family one) because

> an overly broad exception that would be open to significant abuse. To be sure, illicit actors are known to use estate planning techniques to obscure the ownership of residential real estate, and all non-financed transfers of residential real estate not subject to this rule are subject to less oversight from financial institutions than financed transfers and are therefore inherently more vulnerable to money laundering.(Preamble to Final Rules)

Instead, an exception is provided for (i) gift transfers (ii) by an individual (or an individual and his or her spouse) (iii) to a trust of which the same individual(s) are the settlor or grantor. The preamble explains that this will cover many common transfers for estate planning purposes.

> [The exception is for] transfers of residential real property to a trust where the transfer meets the following criteria: (1) the transfer is for no consideration; (2) the transferor of the property is an individual (either alone or with the individual's spouse); and (3) the settlor or grantor of the trust is that same transferor individual, that individual's spouse, or both of them. FinCEN expects that this addition will except many common transfers made for estate planning purposes described by commenters, including transfers described in the exception where the grantor or settlor's family are beneficiaries of the trust, as well as sequential transfers to trusts, such as where the qualified financing is extended to the grantor or settlor rather than to the trust itself and the grantor or settlor then is transferring the secured residential real property for no consideration to the trust.

> … [T]ransfers in which an individual who currently owns residential real property is funding their own trust with that property are believed to be a lower risk for money laundering because the true owner of the property is not obscured when the property is transferred.

Sales to trusts would not be excepted from the reporting requirements under this exception for gifts to trusts.

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

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

The proposed legislation would bring lawyers and accountants within the scope of "financial institutions" who must report under the Bank Secrecy Act if they provide specified services. The legislation directs Treasury to issue regulations that would include lawyers who engage in the following activities as being subject to the new rules: "the formation or registration of a corporation, limited liability company, trust, foundation, limited liability partnership, or other similar entity" or the "acquisition or disposition of an interest" in one of those entities.

Similar legislation was not introduced in 2023 or 2024.

h. **Planning Protocols in 2024.** Planning professionals are preparing their protocols for dealing with reporting obligations of their clients under the CTA. Many law firms and accounting firms are revising their engagement letters to make clear to what extent they will, or more often will not, be responsible for CTA reporting. Reports for the over 30 million entities formed by 2024 that are required to report will not be due until the end of 2024. The reporting for most of these will be straightforward. For those in which questions can arise as to who must be reported, planners may want to wait until near the end of 2024 to see if FinCEN provides further guidance that may assist with particular questions the planner is facing. (However, the FinCEN reporting system may get overloaded in late 2024; by mid-summer, only about 2.7 million reports had been filed.) The following is a summary of steps that planners can be taking to prepare for reporting requirements.

> Recommended best practices will include: (1) developing an appropriate process to identify reporting requirements; (2) gathering required information and documentation from impacted individuals; (3) documenting exception decisions; and (4) monitoring for necessary updates to CTA reporting. Appointing a dedicated reporting individual to adopt this practice is recommended. A common approach being adopted by family offices is to have the job responsibility of the person handling financial KYC regulatory reporting to also include responsibility for CTA reporting.

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

11. Estate Planning for Moderately Wealthy Clients

Many of the comments in this item are from a panel discussion by Mickey Davis and Melissa Willms (Houston, Texas).

a. **Tax Changes Over the Last Decade.**

(1) **Transfer Tax.** The estate and gift exclusion amount and GST exemption amount is $10 million indexed for 2018-2025 ($13.61 million in 2024). This amount will decrease to $5 million indexed in 2026 (about $7.5 million in 2026) unless Congress acts to prevent that decrease. The rate on

transfers not covered by the exclusion/exemption amounts is 40%. As a result of the large exclusions, many moderate estates have no transfer tax concerns. (But beware that trusts created by clients with moderate estates can still be subject to the 40% GST tax if GST exemption is not allocated to the trust, which may happen automatically in many situations, but the planner must assure that GST exemption is allocated to be protected by the exemption.) For non-resident alien individuals, however, the exclusion amount has not been increased and remains at only $60,000.

Portability of the estate tax exclusion amount is available (permanently), which means that a deceased spouse's unused exclusion amount can be used by the surviving spouse for gift or estate tax purposes.

(2) **Income Tax.** For individuals the top bracket for ordinary income is 37%, which applies to taxable income in 2024 of $731,200 for married individuals filing jointly and $609,350 for single individuals. In addition, a 3.8% net income tax applies to net investment income (applying at certain thresholds), resulting in a top rate of 40.8% on ordinary income and 23.8% on capital gains and qualified dividends.

By contrast, the top income tax rate bracket on undistributed income or trusts and estates begins at $15,200 in 2024 ($15,450 for capital gains). Income tax planning for trusts may result in taxing income at the lower brackets of beneficiaries who are not in the top tax brackets for individuals. Also, trusts that permit distributions to charity may reduce income taxes by making transfers that qualify for a charitable deduction for the trust.

Basis adjustments are allowed for property owned by an individual at his or her death. For clients with moderate estates, planning to utilize basis adjustments at death may be more important than saving transfer taxes.

(3) **Changed Analysis.** The ordinary income tax rates exceed the estate tax rates. Basis adjustment planning has become more important as a result of higher capital gains taxes (23.8%) and the fact that transfer taxes do not apply to many with moderate estates. For couples with assets over about $15 million (i.e., about twice the estate exclusion amount after it decreases in 2026), planning decisions become more complex regarding whether to maximize transfer tax savings or the availability of basis adjustments to save income taxes.

b. **What Drives the Estate Plan?** A wide variety of issues may impact estate planning goals and decisions for any particular client. These include total net worth, asset mix, spending habits and growth expectations, potential of inheritance or expectations as current beneficiary of trusts, out-of-state property, age of client and beneficiaries, mental capacity of client and beneficiaries, marital history, marital property agreement, blended family vs. "traditional" family, spendthrift beneficiaries, creditor exposure of client and beneficiaries, concern with possibility of divorce of the client or beneficiaries, charitable intent, tolerance for complexity, desire for control, and view of the "permanency" of tax laws.

c. **Tools Every Estate Planner Should Know How to Use.**

- Fundamental tools (wills, revocable trusts, durable powers of attorney, medical powers of attorney, directives to physicians/living wills, Physicians Orders for Life-Sustaining Treatment (POLST), authorization for disclosure of protected medical information, declaration of guardian for children, declaration of guardian for oneself, appointment of agent for disposition of remains, organ and body donation, and coordinating non-probate assets such as life insurance or retirement plans)
- Outright gifting
- Intra-family loans
- Irrevocable life insurance trusts
- Spousal limited access trusts (SLATs) (sometimes referred to as spousal lifetime access trusts)

- Grantor retained annuity trusts (GRATs)
- Sales to grantor trusts (sometimes referred to as intentionally defective grantor trusts)
- Accidentally perfect grantor trusts
- Charitable gifts
- Using IRAs for charitable gifts
- Donor advised funds
- Portability planning in connection with bypass trusts and marital trusts

d. **A Few Important Planning Issues.**

(1) **Review Formula Bequests.** Review formula clauses that are based on the available exclusion amount to confirm they still achieve the intended result. Be careful about assets that may be included in the gross estate under string statutes or that are not otherwise passing under the decedent's will. For example, a formula bequest equal to of one-half the gross estate could be greater than the entire probate estate.

(2) **Portability Planning.** 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. For a detailed discussion of planning considerations, including major factors in bypass planning versus portability, methods of structuring plans for a couple to maximize planning flexibilities at the first spouse's death, ways of using the first decedent-spouse's estate exemption during the surviving spouse's life, whether to mandate portability, whether to address who pays filing expenses to make the portability election, state estate tax planning considerations, and the financial impact of portability planning decisions, see Item 5 of the Current Developments and Hot Topics Summary (December 2015) found **here**, Item 8 of the Current Developments and Hot Topics Summary (December 2013) found **here**, and Item 3 of Heckerling Musings 2018 and Estate Planning Current Developments (April 2018) found **here**, all available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(3) **Transfer Planning.** Individuals with over about $7.5 million or couples with over $15 million will need to decide whether to take steps to utilize the larger ($13.61 million in 2024) gift exclusion amount to make gift tax-free transfers before the exclusion amount may decrease in 2026 to about $7.5 million. (Some planners refer to the excess exclusion that may be lost in 2026 as the "bonus exclusion.") For a discussion of 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.**

(4) **Transfers with Possible Continued Benefit for Grantor or Grantor's Spouse; Sales to Grantor Trusts.** See Item 2.b(2) above regarding planning to leave some potential benefit or potential cash flow to the donor from the transferred funds.

(5) **SLATs.** A married individual may consider making the gift to a trust of which the spouse is a discretionary beneficiary in case of "rainy days" needs. 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 BLOOMBERG TAX MGMT. ESTS., GIFTS & TRUSTS J. NO. 6 (Nov. 10, 2022).

(6) **Grantor Trust Planning to Provide Flexibility if Grantor Wants to Stop Having to Pay Income Tax on Trust Income.** The grantor's payment of income tax on grantor trust income can result in very significant wealth transfer over a period of time. However, the grantor's payment of that income tax may become overwhelming at some point (or in a particular year when a very large realization event occurs). See Item 2.d above for planning considerations.

(7) **Basis Adjustment Planning.** 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 that may qualify for a stepped-up basis at the person's death under §1014 (assuming §1014 is not repealed). 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, discussed in Item 19.a of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**); or

(4) triggering the "Delaware tax trap."

For a general discussion of each of these planning approaches, see Item 7 of Estate Planning: Current Developments and Hot Topics (December 2014) 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.** For a brief summary of drafting considerations, see Item 19.b(2) of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

One way of applying the general power of appointment approach is utilizing otherwise unused exclusion amounts of parents or grandparents with what has become known as "upstream planning." *See* David A. Handler & Christiana Lazo, *Senior Powers of Appointment*, TRUSTS & ESTATES 14 (Sept. 2020). Upstream Planning is discussed Item 7.c of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. *See* Mickey Davis & Melissa Willms, *Estate Planning for Modest Estates: Practical Tools Every Planner Should Know,* 58TH HECKERLING INST. ON EST. PL., at Section III.I (2024) ("accidentally perfect grantor trusts"); Turney Berry, *The "Hook" of Increased Income Tax Basis*, TRUST & ESTATES 10 (April 2018).

(8) **Trust Flexibility.** Including provisions to provide flexibility to accommodate changing circumstances or changing tax laws can be very helpful. For a discussion of various trust planning and drafting pointers to build in flexibility for trusts, see Item 11 of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(9) **State Estate Taxes**. For planning in states with state estate taxes (17 states and the District of Columbia have state estate and/or inheritance tax)), 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 is not portable (except in Hawaii and Maryland), necessitating additional planning in states with state estate taxes.

e. **Portability Planning Financial Impact.** Diana Zeydel (Miami, Florida) has drawn various conclusions from financial modeling (using a "Monte Carlo analysis" to take into consideration the volatility of possible outcomes) of likely portability planning outcomes with a diversified portfolio.

(3) **Leave Cushion for Clients' Lifestyle Needs.** A key element of any planning is to give the clients assurance that sufficient assets will be available for their lifestyle needs for life. Financial modeling can examine the effects of planning strategies if there are "down" markets in the future. Realize that for everyone, cutting back on lifestyle is extremely difficult, whether someone is used to living on $50,000 per year or $2 million per year.

(4) **Long "Overlife."** Surviving spouses typically have an "overlife" of 10 years or more. That is long enough for assets to have substantial appreciation and making the right choice can have a significant financial impact on the family.

(5) **Less Advantage With Higher Exemption Amounts.** The financial impact to a family of doing planning vs. no planning and the effects among various different strategies is not nearly as dramatic as before ATRA—because of the large, indexed exemptions.

(6) **State Taxes.** The credit shelter trust vs. portability decision can vary greatly depending on the state estate tax (if any) that applies to the spouses and the state income tax that applies to the children. If there is no state estate tax for the surviving spouse and a high state income tax for the children, portability may be favored. If there is a state estate tax for the surviving spouse and no state income tax for the children, the credit shelter trust may be favored.

(7) **Couple With $10 Million.** For a couple with $10 million that spends 4% annually, leaving assets outright to the surviving spouse or in a QTIP trust and relying on portability will likely result in no estate tax being payable at the surviving spouse's subsequent death (the median result is that the assets will decline to about $9 million). However, there is no certainty of this. In 5% of the cases, the assets could grow to $18-20 million. Using a QTIP trust to make use of the first spouse's GST exemption means that most of the couple's assets would likely end up in GST-tax-exempt trusts.

(8) **Couple With $30 Million.** For a couple with $30 million (or more), the likelihood of achieving significant estate tax savings by using a credit shelter trust rather than relying on portability is very high, even if the spending level is 5%.

(9) **More May Pass in GST-Tax-Exempt Fashion.** A key result of using these approaches is that substantially more of the wealth passes to descendants in a GST exempt nature. As a practical matter, the portion of the estate that is non-exempt will likely be consumed by the children-generation.

(10) **Diversified Portfolio With Typical Turnover.** For clients with a diversified portfolio with typical turnover for a diversified portfolio, whether a basis step-up is available at the second spouse's death is not overly significant. (Gains are realized significantly during the surviving spouse's lifetime, and there is not a great deal of unrealized appreciation that would lose the benefit of a basis step-up.)

f. **Further Discussion.** For further discussion of these issues, see Item 4 of Estate Planning: Current Developments and Hot Topics (December 2014) found **here**, Item 3 of Heckerling Musings 2018 and Estate Planning Current Developments (April 2018) found **here**, and Item 7 of Estate Planning Current Developments and Hot Topics (May 2021) found **here**, all available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

12. Defined Value Formula Transfer Issues; *Sorensen v. Commissioner,* T.C. Docket 24797-18, 24798-18, 20284-19, 20285-19 (Decision Entered Aug. 22, 2022)

a. **Significance.** The gift/estate exclusion amount is scheduled to revert from $10 million (indexed) to $5 million (indexed) in 2026, so a shrinking window of opportunity is available for making use of the larger exclusion amounts with lifetime gifts. Mid to late 2025 could be a very busy time for transfer planning as we wait to see whether legislation will be enacted to extend the $10 million (indexed)

exclusion amount. A practical problem for transfers made in late 2025 is that the planners will not have time to get appraisals before the end of 2025, and some kind of formula transfer may be necessary.

Furthermore, many clients are extremely reluctant to pay current gift taxes. Perhaps the most important advantage of the increased gift tax exclusion amount for many individuals is the "cushion" effect – the ability to make gifts in excess of $5 million, but considerably less than $13,160,000 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). But for large transfers of hard-to-value assets approaching the client's remaining gift exclusion amount, defined value formula transfers are commonly used in light of inherent valuation uncertainties.

b. **Types of Value Formula Transfers.** Six basic types of these clauses exist.

(3) **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*).

(4) **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]").

(5) **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]").

(6) **Price Adjustment (*King*).** 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.").

(7) **Subsequent Appraisal (*Nelson*).** When an appraisal cannot be obtained before the transfer, the transfer clause could transfer an amount of assets having a specific dollar value, as determined by appraisal from a particular firm within a certain time. The IRS does not find that abusive. (If shares of a company are being transferred, by the time the gift tax return is filed, the number of shares transferred will have been determined; the IRS could contest the value of that number of shares if it wishes to do so.) (Example from *Nelson v. Commissioner*, 17 F.4th 556 (5th Cir. 2021), *aff'g*, T.C. Memo. 2020-81: "[Mrs. Nelson] desires to make a gift and to assign to * * * [the Trust] her right, title, and interest in a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 * * *, as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment.")

(8) **Reversion.** Reversions to the donor of the 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).

c. **Planning Considerations For Particular Types of Clauses.**

(3) **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;
- GRAT (for both lifetime QTIPs and GRATs, consider having different trustees and some differences in the beneficiaries compared to 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; provide initial funding of the spillover GRAT contemporaneously with the initial formula gift to the grantor trust so that there is no uncertainty of whether the GRAT is funded and whether annuity payments are required; that way annuity payments will be required to be made, creating payments that can be adjusted using typical adjustment clauses if the annuity is finally determined to be incorrectly computed); and
- Spouse – The excess amount could pass outright to the donor's spouse.

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

(4) ***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 10.d below for a discussion of IRS arguments made against a *Wandry* transfer in *Sorensen v. Commissioner*.

(5) ***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, the 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.

(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* (September 2023) 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 10.d(3) 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.

d. ***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).**

(3) **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).

The company succeeded and grew substantially. In late 2014 the brothers 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.

(4) **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?

(5) **IRS Arguments Regarding Reporting Inconsistency.** The IRS argued that for various reasons, the donors each relinquished dominion and control of 9,385 shares on 12/31/14, not a formula amount because of various reporting glitches.

(a) **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.]

(b) **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.]

(c) **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.]

(d) **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.]

Other arguments by the IRS in its brief are summarized in Item 13.c of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

(6) **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.

(7) **Observations.**

(a) **Motivation to Settle.** 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).]

(b) **Values.** 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?

(c) **Penalties.** The 10% negligence penalty under §6662(a) was applied to the 2015 sale 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).

(d) **Successful Transfer Transaction.** 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%.

(e) **Drafting.** 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*.

(f) **Reporting Consistency.** As discussed in Item 10.d(3) 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.

(g) ***Wandry* Transfers in Audit.** The treatment of *Wandry* transfers varies among IRS estate and gift tax attorneys, but the national office of the IRS does not like *Wandry* clauses.

(h) **Highly Appreciating Assets.** Be wary of using *Wandry* transfers if the transferred assets could explode in value. A change in the finally determined gift tax value could result in many of the transferred assets remaining with the donor – and all the appreciation attributable those assets remaining in the donor's gross estate.

(i) **Combined *Wandry*/*King* Transfer.** An alternative to assure that all of a particular block of assets is transferred is to use a combined *Wandry*/*King* approach as discussed in Item 10.c(4) above.

(8) **Resources.** For a more detailed discussion of the IRS arguments in *Sorensen*, see Item 13.c of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** 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* (September 2023) found **here,** both available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

13. Current Issues in Estate and Gift Tax Audits and Litigation (Including §2036 Issues For FLPs and LLCs)

The highlights of audit and litigation issues in this Item are from comments by John Porter (Houston, Texas).

a. **Anticipate Disputes.** Prepare for audits and litigation at the planning stage. The IRS issues broad discovery requests. (Example: "All documents relating to the creation of the entity from any attorney, accountant or firm involved in recommending the creation of the entity.") The planner's files can be subpoenaed, including emails.

The IRS is staffing up and we can expect more estate and gift tax audits.

b. **Common IRS Challenges.** Common IRS challenges involve valuation, formula transfers, QTIP termination, promissory notes, sales to grantor trusts, GRATs, penalties, §2036, or split-dollar life insurance. Life insurance transfers can also create challenges. See Items 23 and 24 below for a discussion of recently settled cases (*DeMatteo* and *Cinader*) regarding life insurance valuation issues.

c. **Valuation—Cases Giving No Weight to Liquidation Value.** The recent *Cecil* case (see Item 19 below) held that no weight was given to the liquidation value of a company when the transferred interests had no ability to force the liquidation of the company, and the company had a long history suggesting that it would not be liquidated. Other cases involving that same issue are *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101 "(income-based approach … is more appropriate than …

NAV method valuation"); *Estate of Giustina v. Commissioner*, 586 Fed. Appx. 417 (9th Cir. 2014) (in valuing an interest in a timber partnership that could not unilaterally force liquidation, applying 25% likelihood to possibility of liquidation was clearly erroneous, despite the hypothetical possibility that the owner of that interest could form a voting bloc block with other limited partners to liquidate); *Estate of Dunn v. Commissioner*, 301 F.3d 339 5th Cir. 2002) (court applied 85/15 earnings-based to asset-based weighting ratio rather than the lower court's 35/65 weighting considering that the company was a going concern that would be purchased for continued operation, not liquidation or other asset disposition); *Estate of Watts v. Commissioner*, 823 F.2d 483 (11th Cir. 1987) (15% interest in general partnership with timberland that could not force liquidation was valued based on its going concern value, not its liquidation value; conclusion based on absence of right to force liquidation "because of legal restriction placed upon the partners' interest by contract, fully commensurate with Oregon law," not on the remaining partners' intent to continue the partnership).

d. **Defined Value Clauses.** See Item 10 above regarding planning issues with gifts and sales using defined value clauses.

e. **QTIP Termination.** The IRS is increasingly reviewing planning with assets in QTIP trusts, including the termination of QTIP trusts followed by transfer planning transactions by the spouse with assets that had been in the QTIP trust. See Items 27 and 28 below28 below.

f. **Adequate Disclosure.** Making "adequate disclosure" of transfers on a gift tax return will start the three-year period for additional assessments to begin running. *Schlapfer v. Commissioner* applied a substantial compliance analysis, discussed in Item 12 below.

g. **Promissory Notes.** The IRS examines whether the loan transaction is a bona fide loan or a gift. The major factor is whether a reasonable expectation of repayment exists.

In addition, the IRS reviews the proper application of §7872 to the note. Under §7872, below market loans that are gift loans may result in a deemed gift from the lender to the borrower and a deemed interest payment from the borrower to the lender. A note that arises from a sale for full consideration may not be subject to §7872 as a gift loan. Money loans are not subject to the complex OID rules. (See Item 16 below.)

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

i. 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 CCA 202152018 suggests that gift issues can arise even if the annuity is described as a formula; see Item 21 of Estate Planning Current Developments and Hot Topics for 2022 found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.)

- 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 exemption 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, and *Baty v. Commissioner* are discussed in Items 21 and 22 of Estate Planning Current Developments and Hot Topics for 2022 found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**).
- 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* or *King*

type formula approach for annuity payments or exercises of substitution powers, although the use of a *Wandry* or *King* 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 (discussed in Item 21 of Estate Planning Current Developments and Hot Topics for 2022 found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**).

j. **Sales to Grantor Trusts.**

(3) **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 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.).

(4) **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* (September 2023) 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. *Cf. Pierre v. Commissioner*, T.C. Memo. 2010-106 (2010) (step transaction doctrine applied to collapse 9.5% gift and 40.5% sale, made at approximately the same time, to each trust for valuation purposes.)

k. **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.

(3) **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.

(4) **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.

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 a 62-year-old spouse.)

(5) **Resources.** For a detailed discussion of SLATs and "non-reciprocal" SLATs, including a discussion of the §2036 and §2038 issues and creditor issues, see Items 78 and 80 of the ACTEC 2020 Annual Meeting Musings (March 2020) found **here**, Item 10.i. of Estate Planning Current Developments and Hot Topics (December 2019) found **here**, and Item 16 of the Current Developments and Hot Topics Summary (December 2013) found **here**, all available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** 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 BLOOMBERG TAX MGMT. ESTS., GIFTS & TRUSTS J. NO. 6 (Nov. 10, 2022).

I. **Section 2036; FLP and LLC Cases.** Whether §2036 applies to assets transferred to entities is the **most litigated issue** in the transfer tax area.

(3) **Overview of Section 2036 Issues.** For an 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.

Section 2036(a)(1). The IRS typically argues that assets should be included under §2036(a)(1) as a transfer to the FLP/LLC with an implied agreement of retained enjoyment. The 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.**

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*).

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*).

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, see Item 17 of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

(4) **Summary of §2036 FLP/LLC Cases (14-24, 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.**

(5) **Ramifications.** Ramifications if the IRS is successful in applying §2036 or 2038 to bring all assets of the entity into the estate include: (1) estate inclusion of entity assets may apply even if interests in the entity are transferred during life (*Harper*, *Korby*), (2) the marital or charitable deduction may not be applicable or may be greatly reduced (*Turner*), and (3) double counting of assets included in the gross estate may result (*Powell*).

(6) **Bona Fide Sale for Full Consideration Defense.** 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. John Porter points out that factors that have been applied in finding that a "significant and legitimate non-tax reason" (*Bongard*) existed under a case-by-case for an entity are:

- Centralized asset management (*Stone, Kimbell, Mirowski, Black*)
- Involving next generation in management (*Stone, Mirowski, Murphy*)
- Protection from creditors/failed marriage (*Kimbell, Black, Murphy, Shurtz*)
- Preservation of investment philosophy (*Schutt, Murphy, Miller*)
- Avoiding fractionalization of assets (*Church, Kimbell, Murphy*)
- Avoiding imprudent expenditures by future generations (*Murphy, Black*)

(7) **Potential Ways to Avoid *Powell* §2036(a)(2) Holding.** The §2036(a)(2) issue is important because clients often like to keep as much control as possible with respect to transferred assets. 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 clients who want to keep as much control as possible, the planner may want to start with the client having control of investment and possibly distribution decisions for entities owned by the trust, but eventually give up control over distribution decisions (hopefully more than three years before death).

John Porter suggests the following as possible ways of avoiding a *Powell* argument by the IRS:

- Satisfy bona fide sale test
- Create two classes of interests
    - One with vote on dissolution/amendment
    - One without vote on dissolution/amendment
- Senior family member disposes of all interests in entity more than three years before death (does bona fide sale for full consideration of interest avoid the three year rule [§2035(d)]?)

- Terminate entity more than three years before death (be careful with potential income tax issues)

For a more detailed 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.**

m. **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 discount 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 (2000)	Securities	Tax	31%
Knight (2000)	Securities/real estate	Tax	15%
Jones (2001)	Real estate	Tax	8%; 44%
Dailey (2001)	Securities	Tax	40%
Adams (2001)	Securities/real estate/minerals	Fed. Dist.	54%
Church (2002)	Securities/real estate	Fed. Dist.	63%
McCord (2003)	Securities/real estate	Tax	32%
Lappo (2003)	Securities/real estate	Tax	35.4%
Peracchio (2003)	Securities	Tax	29.5%
Deputy (2003)	Boat company	Tax	30%
Green (2003)	Bank stock	Tax	46%
Thompson (2004)	Publishing company	Tax	40.5%
Kelley (2005)	Cash	Tax	32%
Temple (2006)	Marketable securities	Fed. Dist.	21.25%
Temple (2006)	Ranch	Fed. Dist.	38%
Temple (2006)	Winery	Fed. Dist.	60%
Astleford (2008)	Real estate	Tax	30% (GP); 36% (LP)
Holman (2008)	Dell stock	Tax	22.5%
Keller (2009)	Securities	Fed. Dist.	47.5%

Case	Assets	Court	Discount from NAV/ Proportionate Entity Value
Murphy (2009)	Securities/real estate	Fed. Dist.	41%
Pierre II (2010)	Securities	Tax	35.6%
Levy (2010)	Undeveloped real estate	Fed. Dist. (jury)	0 (valued at actual sales proceeds with no discount)
Gallagher (2011)	Publishing company	Tax	47%
Koons (2013)	Securities	Tax	7.5%; Estate owned 70.42% of voting interests and could remove limitation on distributions
Richmond (2014)	Marketable securities	Tax	46.5% (37% LOC/LOM & 15% BIG)
Giustina (2016)	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)
Streightoff (2018)	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 (2019)	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 (2019)	Sawmill & timber	Tax	35% lack of marketability discount from value of noncontrolling interest
Grieve (2020)	Securities	Tax	35% for one LLC and 34.5% for another LLC (98.8% non-voting LLC interest)
Nelson (2020)	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 (2021)	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 (2021)	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 Front Lines – Current Issues in Estate and Gift Tax Audits and Litigation, 58TH ANN. HECKERLING INST. ON EST. PL. (2024); 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).

n. **Valuation Penalties; *Morrissette*.** *Morrissette* (discussed in Item 17.c(3) and Item 20 of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**) 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. Accuracy-related penalties under §6662 and failure to file and pay penalties under §6651 were avoided in *Huffman v. Commissioner* because of the reasonable reliance on professional advice, as discussed in Item 22 below.

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

a. **Synopsis.** This is the **first reported case** with a detailed discussion of the adequate disclosure requirements under the gift tax adequate disclosure regulations (Reg. §301.6501(c)-1(f)). It applies a lenient "substantial compliance" approach (this is in contrast to some informal guidance from IRS attorneys that has applied a stricter approach).

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

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

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

Some planners view the adequate disclosure regulations as stating a general rule (the information apprises the IRS of the nature and basis of valuation of the gift) and providing two safe harbors – a "description safe harbor" and an "appraisal safe harbor." The court did not analyze the regulations as stating a general rule and safe harbors but analyzed whether the disclosure substantially complied with the elements of the description safe harbor. The court viewed those elements as "not mandatory, but … as guidance to inform them on a way to satisfy adequate disclosure." That sounds like a general rule and safe harbor analysis, but the court did not use those terms.

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

- Can be satisfied by substantial compliance; and

- Are not mandatory, but act as guidance to inform donors on a way to satisfy adequate disclosure.

The time for appealing the case has lapsed, and this Tax Court case has not been appealed, and so far, the IRS has not filed an acquiescence or nonacquiescence.

Schlapfer v. Commissioner, T.C. Memo. 2023-65 (May 22, 2023) (Judge Buch).

b. **Basic Facts.** For a summary of the somewhat convoluted facts of the case, see Item 14.b of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

> The documents he attached to, and referenced in, his return provided the Commissioner with enough information to satisfy adequate disclosure. Therefore, the period of limitations to assess the gift tax commenced when the return was filed; and because the Commissioner issued the notice of deficiency more than three years after the filing, the Commissioner is barred from assessing gift tax.

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

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

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

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

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

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

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

(4) **Statute.** If a gift is not reported on a gift tax return, gift taxes may be assessed at any time. The statute provides an exception for "any item which is disclosed in [a gift tax return], or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item." §6501(c)(9). A similar statement is in the statute for the six-year limitations period that applies if omitted gifts exceed 25 percent of the gifts reported on a gift tax return. The six-year limitations period does not apply to any item "disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the [IRS] of the nature and amount of such item." §6501(e)(2). The court summarized the "essence" of the statute as providing the IRS "with a viable way to identify gift tax returns that should be examined with minimum expenditure of resources. T.D. 8845, 1999-2 C.B. 683."

(5) **Cases.** Cases generally have looked to the purpose of disclosure, and whether disclosure is sufficient to alert the IRS whether to select a return for examination. *See Thiessen v. Commissioner*, 146 T.C. 100, 114 (2016) (quoting *Estate of Fry v. Commissioner*, 88 T.C. 1020, 1023 (1987) (cited in the *Schlapfer* opinion). **[Observation:** These are income tax cases addressing the application of the adequate disclosure exception in §6501(e)(1)(B)(iii) for purposes

of the six-year limitations period where there is an omission of more than 25% of gross income. Both cases found that the taxpayer had not adequately disclosed omitted income. See Item 12.e(3) below regarding case discussions.]

(6) **Regulations.** Regulations, finalized in November 1999, are effective for gifts made after December 31, 1996.

(a) **First Sentence – General Rule.** The first sentence of the regulation, tracking the statute, states a general rule: "A transfer will be adequately disclosed on the return only if it is reported in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and the basis for the value so reported." Reg. §301.6501(c)-1(f)(2).

(b) **Second Sentence – Information So Gift "Considered Adequately Disclosed."** The next sentence provides information describing the gift and its valuation that, if disclosed, will result in a gift being "considered adequately disclosed." The opinion lists five items of information and subsequently analyzes whether those five items were supplied. The five elements in the regulation, as excerpted in the opinion, are:

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

Reg. §301.6501(c)-1(f)(2).

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

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

Observation: The court's description of the first sentence of the regulation (with its "only if" statement) sounds like the description of a general rule, and the description of the second sentence (with its "will be considered adequately disclosed" statement) sounds like a safe harbor, although the court did not use those precise terms. Indeed, the court refers to the elements of what many regard as a safe harbor in the second sentence as "requirements," albeit "requirements" that it views as "not mandatory" but only as guidance of what is "sufficient to alert the [IRS] to the nature of the gift." The opinion makes no reference to the

appraisal safe harbor, which is an objective way of supplying the information required in subparagraph (iv) of Reg. §301.6590(c)-1(f)(2) about the method used to value the property.

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

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

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

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

(9) **Substantial Compliance with Elements of the Description "Requirements."**

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

> As previously mentioned, disclosure is adequate if it is sufficiently detailed to alert the Commissioner to the nature of the transaction so that the decision to select a return for audit is reasonably informed. *Thiessen*, 146 T.C. at 114. …
>
> Mr. Schlapfer provided enough information to satisfy this requirement through substantial compliance. While he may have failed to describe the gift in the correct way (assuming the gift is the UVL Policy), he did provide information to describe the underlying property that was transferred. Mr. Schlapfer asserts that he chose to disclose the assets held in the insurance policy instead of the actual policy because the OVDP required him to disregard entities holding foreign assets. The UVL Policy's value comes primarily from EMG stock, so Mr. Schlapfer's describing the transferred property as EMG stock goes to the nature of the gift. Because this description was sufficient to alert the Commissioner to the nature of the gift, Mr. Schlapfer substantially complied with this requirement.

(b) **Identity of Parties.** Donor did not strictly comply with the "requirement" of identifying the identity of, and his relationship to, each transferee. The Offshore Entity Statement stated that the gift was made to Donor's mother, with no mention of his aunt or uncle. Nevertheless, Donor substantially complied with this "requirement." The statement listing Donor's mother as the transferee provided the IRS with enough information to understand the donee was a "member of his family," and failing to provide the names of his aunt and uncle "does not make a meaningful difference in understanding the nature of the transfer."

(c) **Method to Determine Value of Gift.** The regulation refers to providing "a detailed description of the method used to determine the fair market value of property transferred, including" considerable detailed information for different types of property. Donor did not provide any statement describing how he valued the fair market value of the gift. Also, he did not provide all the detailed financial information listed in the regulation, but he did provide all documents listed in the instructions to Form 709 for stock of close corporations ("attach balances sheets, particularly the one nearest the date of the gift, and statements of net earnings or operating results and dividends paid for each of the 5 preceding years"). That was enough to show the IRS how he valued the EMG stock, and the UVL policy value stems primarily from the EMG stock, so he substantially complied with this "requirement":

> Although Mr. Schlapfer did not provide all the financial documentation listed in the regulation, he provided the information identified in the 2006 Form 709 instructions, which was enough to show the IRS how he determined the fair market value of the EMG stock. Therefore, he substantially complied with this requirement.
>
> Furthermore, Mr. Schlapfer substantially complied even if the gift is the UVL Policy. The UVL Policy's principal asset is the EMG stock, and the documents we considered above were enough to apprise the Commissioner of the method used to determine the fair market value of the EMG stock. Because the UVL Policy's value stems primarily from the EMG stock, those same documents can be used to illustrate the method used to determine the fair market value of the UVL Policy.

e. **Observations.**

(3) **This First Case to Address Adequate Disclosure Regulation Applies Substantial Compliance Analysis and Effectively Treats Disclosure Elements as Safe Harbors.** The IRS has been aggressive in applying the adequate disclosure requirements strictly, in order to prevent the running of the gift tax statute of limitations. IRS notices and informal guidance have generally been very strict (and sometimes harsh) in applying the requirements, including treating the elements of the safe harbors in the regulations as mandatory requirements. This case is the **first case** to address in any detail what constitutes substantial compliance with the adequate disclosure regulations. The case takes a **very reasonable approach** to finding that substantial compliance exists despite various instances of failing to comply with the guidelines in the regulations. There have been few cases discussing the gift tax adequate disclosure regulation.

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

Observation: Clary Redd (St. Louis) notes the very low standard applied by the court regarding what is required for adequate disclosure on a gift tax return – "The donor reported the wrong assets, in the wrong year, and reported the wrong donees in flagrant violation of the adequate disclosure rules. Nevertheless, the Tax Court bends over backward like a human pretzel to give a favorable result."

(4) **A Little History; Taxpayer Relief Act of 1997.** The Taxpayer Relief Act of 1997 made substantial changes to the statute of limitations applicable for gift taxes and for determining the amount of adjustable taxable gifts for estate tax purposes.

(a) **Unlimited Period of Assessment for Gifts Not Adequately Disclosed.** The Omnibus Budget Reconciliation Act of 1990, while adding Chapter 14 to the Code, also added §6501(c)(9), providing an unlimited period for assessment of gift tax for gifts valued under §2701 or §2702 that were not adequately disclosed on a gift tax return. The 1997 Act amended §6501(c)(9), effective for all gifts after 1996, to extend the unlimited period of assessment for gift taxes to all gifts that are not adequately disclosed on a gift tax return, even if a return was filed for the year but did not adequately disclose such particular gifts.

(b) **No Requirement To Pay Gift Tax To Commence Period of Limitations.** Prior to the 1997 Act, the three-year statute of limitations, for assessment of gift tax and for determining the amount of gifts in preceding calendar quarters, would begin to run on gifts in a year in which

a gift tax return was filed *and gift tax was paid*. §2504(c). Effective for gifts made after August 5, 1997, the requirement of paying gift tax for the statute of limitations to begin running was deleted.

(c) **No Revaluation for Estate Tax Purposes.** Prior to the 1997 Act, gifts could be revalued at the donor's death for purposes of determining the amount of adjusted taxable gifts added into the estate tax calculation, but the effect was only to push the estate into higher estate tax brackets. *Estate of Smith v. Commissioner*, 94 T.C. 872 (1990), *acq*. 1990-2 C.B. 1. The 1997 Act changed that and provided that gifts adequately disclosed on a gift tax return, and for which the period of limitations on assessment of gift tax has run, cannot be revalued for estate tax purposes. §2001(f) (effective for gifts made after August 5, 1997).

(d) **Regulations.** Regulations were proposed to implement the changes under the 1997 Act on December 21, 1998, and were finalized on November 18, 1999. The proposed regulation had stated that a gift would be adequately disclosed "only if" specified information is included in the return. This was changed in the final regulations, which require that a gift be reported "in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and basis for the value so reported." Reg. §301.6501(c)-1(f)(2). The next sentence says that gifts "will be considered adequately disclosed" if the return provides the information listed in five subparagraphs.

(e) **Resource.** For a detailed discussion of the history of the Taxpayer Relief Act of 1997 and the adequate disclosure regulations, see Ronald Aucutt, The Statute of Limitations and Disclosure Rules for Gifts (July 2023), found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**).

(5) **Prior Cases.** This is the **first reported case** with a detailed analysis of the requirements for adequate disclosure under Reg. §301.6501(c)-1(f)(2). Many cases, though, have discussed the six-year statutes for substantial omissions of gross income (now §6501(e)(1)(B)(iii) or of gross estate assets or gifts (§6501(e)(2)) with their similar exception for adequate disclosures. For a discussion of these prior cases and prior IRS informal guidance, see Item 14.e.(4) of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

(a) **Description Safe Harbor.** The five elements of the description safe harbor are listed in Item 12.d(4)(b) above, as summarized in the *Schlapfer* opinion.

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

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

- Use an appraisal dated as close in time to the gift as possible (assuming economic conditions have not changed) and be ready to argue that the information is sufficient to satisfy the general rule of the adequate disclosure regulations (apprising the IRS of

the nature and basis of valuation of the gift), or that the disclosure substantially complies with the appraisal safe harbor.

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

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

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

The regulation for non-gift transactions states that the transfer will be considered adequately disclosed "only if" (1) information in four of the five items in the second sentence of Reg. §301.6501(c)-1(f)(2) are provided (the items other than valuation information) and (2) an

explanation states why the transfer is not a gift. Reg. §301.6550(c)-1(f)(4). Thus, under the regulations the four items are not merely a safe harbor but must be provided to constitute adequate disclosure of a non-gift transaction. They are (i) description of the transferred property and any consideration received, (ii) identity and relationship of the transferee, (iii) specified information about the trust recipient if the transfer is made to a trust, and (iv) a statement describing any position contrary to regulations or rulings published before the transfer. Interestingly, valuation information is not required, even though it would seem to be very relevant in determining whether a sale was for full consideration so that the transfer was a non-gift transaction.

(8) **Split Gifts.** For split gifts under §2513, compliance with the adequate disclosure requirements by the donor spouse will be treated as adequate disclosure by the consenting spouse. §301.6501(c)-1(f)(6).

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

15. Income Tax Effects of Sale to Grantor Trust; Gain Realization at the Grantor's Death?

Carlyn McCaffrey (New York, New York) discussed the vexing (and unanswered) issues about whether there is gain realization at the grantor's death (or otherwise when grantor trust status ends) for a sale from a grantor to a grantor trust in exchange for a promissory note if the note from the trust has not been paid by the time of the grantor's death. The following discussion is based on comments from Carlyn (often verbatim).

a. **Trust Note to Grantor.** Rev. Rul. 2023-2 doesn't answer whether gain would be realized at the grantor's death. In fact, the recital of facts at the beginning of the ruling tells us that at the grantor's death the liabilities of the trust do not exceed basis and neither the trust nor the grantor held a note in which the other was the obligor.

Some advisors think that if grantor trust status is turned off for any reason, including at the death of the grantor, gain will be recognized to the extent of the excess of the amount of the outstanding note to the grantor over the basis in the property. Suppose for example, that grantor, G, sold an asset to her grantor trust for $50 when it had a basis of zero. At the time of her death the property is worth $100 and the note is still $50. Under this point of view, which relies on *Crane v. Commissioner* and the section 1001 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), the grantor or the trust (which one is not clear) would have gain of a $50. Carlyn does not think this is the right answer. The regulations say the amount of non-recourse liabilities that a grantor is relieved of when she disposes of property is treated as an amount realized. But in this case, although property is disposed of when grantor trust status ends, whether it ends during the individual's lifetime or at death, nobody was relieved of any non-recourse liability, because the liability owed from the trust to the grantor never existed for income tax purposes. Only at the point of death (or at any other point that grantor trust status terminated) did the trust obligation to G spring into existence.

For support for the position that no gain is realized at death if the trust's note to the grantor has not been repaid by the time of the grantor's death, see Jonathan Blattmachr, Mitchell Gans, & Hugh Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149, 149-159 (Sept. 2002); Mitchell Gans & Jonathan Blattmachr, *No Gain at Death*, TRUSTS & ESTATES 34, 34-37 (Feb. 2010); Elliott Manning & Jerome Hesch, *Deferred Payment*

Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements, 24 BLOOMBERG TAX MGMT. ESTS., GIFTS & TRUSTS J. No. 1, 3 (Jan. 14, 1999).

b. **Trust Note to Third Party.** The result might be different if the trust borrowed funds from a third party to purchase assets from the grantor. For income tax purposes, the trust's debt to the third party would be treated as nonrecourse liability of the grantor. The disposition of the grantor's interest in the asset by reason of the trust becoming a nongrantor trust would have relieved the grantor of the non-recourse liability. Unless an exception exists under the §1001 regulations for disposition by death, which is unclear, the termination of grantor trust status by death would result in an amount realized equal to the excess of debt over basis.

If the fact pattern is analyzed by treating the sale as taking place at the grantor's death, it leaves open the question of precisely when the sale took place and the consequences of the sale. Similar to the question not answered by Rev. Rul. 2023-2, should the basis receive a §1014 basis adjustment immediately before sale? That seems like the wrong result because the grantor trust received the asset by purchase, not by inheritance or by any of the other methods described in §1014(b).

There are two other possible answers to this question.

- (1) The first is that the trust purchased the stock from the grantor trust simultaneously with her death, and therefore the trust has a $100 asset with the cost of $50, and the grantor's estate has a gain of $50 which, depending on the nature of the asset, might be eligible for installment sale treatment.
- (2) The second is that the trust purchased the asset immediately before the grantor's death for the amount of the note. Therefore, the trust has a $100 asset with a basis of zero, the grantor's estate has a $50 note, and there would be no gain realization at death.

Of these two approaches, which is preferable? If the estate has sufficient liquidity, the first approach might actually yield a preferable tax result, because in that case, while income tax is paid immediately, the grantor's estate will get an estate tax deduction for the amount of the tax liability, and as a result, the trust itself will have an increase in basis. The other thing going for that approach is that it is actually perfectly consistent with what would have happened if the grantor had sold the asset to a nongrantor trust during life. Her estate would have been depleted by the amount of the income tax paid on the gain.

c. **Planning Alternative: Transfers by Grantor and Trust to LLC.** If a client wants to make sure that the estate is not forced to recognize gain in case approach number (1) above is correct, consider using an approach that Paul Lee (New York, New York) suggests. While the grantor is still alive, the grantor and the grantor trust form a limited liability company. The grantor contributes the note to the LLC, and the trust contributes the $100 asset subject to the note. The LLC gives each member the right to withdraw any time and receive an amount equal to 50% of the value of the partnership. Each of them at that point is a 50% owner of the LLC, and the note naturally disappears because the LLC owes this amount to itself. When G dies, the LLC and the estate are treated as having formed a tax partnership with each contributing 50% of the assets. G has a basis step up in her interest in the LLC, so G's estate has a basis equal to $50, and the trust has a basis of zero, the carryover basis it received on the purchase. That is the result you would get in approach number (2) without the risk that approach number (1) is actually the right approach.

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

a. **Overview.** The SECURE Act made various changes regarding retirement benefits including (i) changing the required beginning date (RBD) for required minimum distributions (RMDs) (April 1 of the following year) from age 70½ to 72 (and SECURE 2.0 changes it to age 73 beginning in 2023 and to age 75 beginning in 2033), (ii) eliminating the prohibition on contributions to an IRA after age 70½ (but if an individual both contributes to an IRA and arranges for a qualified charitable distribution (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 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; Extension Notices.** 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 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, correction published March 14, 2022, in 2022-11 I.R.B. 828). The proposed regulations reflected statutory amendments since the required minimum distribution regulations were last issued, clarified issues that had been raised in public comments and private ruling requests, and replaced 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/legislative-comments/actec-submits-comments-on-proposed-regulations-irs-reg-105954-20-the-proposed-regulations-address-the-required-minimum-distribution-requirements-for-plans-qualified-under-code-section-401a-and-are/**).

The proposed regulations regarding required minimum distributions were 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 to REG-105954-20 at 77-78.

The IRS delayed the issuance of final RMD regulations until the provisions impacted by SECURE 2.0 could be revised. Notice 2023-54, issued in July 2023, provided transition relief related to the RMD age increases in SECURE 2.0 and waived excise taxes for the failure to make certain required minimum distributions. It also announced that the final RMD regulations would not apply until 2024. Notice 2024-35 extends the waiver of excise taxes for the failure to make "specified RMDs" in 2024 and states that the final RMD regulations will not apply until 2025. Guidance in the form of questions and answers regarding certain provisions in SECURE 2.0 was released December 20, 2023, in Notice 2024-2, 2024-2 I.R.B. 316 (dated January 8, 2024).

For a detailed summary of planning issues under the SECURE Act for trusts as beneficiaries, including Natalie Choate's analysis for testing a trust beneficiary, see Item 4.d.-e. of Estate Planning Current Developments and Hot Topics (December 2023) found **here**. For a fairly detailed summary of highlights of the proposed regulations, see Item 4.d of Estate Planning Current Developments and Hot Topics 2022 (December 2022) found **here**. 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**. All of those documents are available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

c. **Final Regulations Regarding Distribution Rules.** The long-awaited final regulations for distributions from retirement plans and IRAs, including implementation of changes made by the SECURE Act (and some changes by the SECURE 2.0 Act) were released July 18, 2024, and published in the Federal

Register on July 19, 2024. The final regulations largely follow the 2022 proposed regulations but include various clarifications and some significant changes. Some of the changes reflected in the final regulations are briefly summarized below.

(3) **Effective Date.** The required minimum distribution rules in the final regulations apply generally (at least with respect to the distribution discussed in this summary) for distributions in calendar years beginning in 2025. For earlier years, the preexisting final regulations apply, as adjusted for a "reasonable, good faith interpretation" of changes made in the SECURE Act, and for 2023 and 2024, changes in certain sections of the SECURE 2.0 Act.

(4) **Retention of Requirement That 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 in a position taken at one point in IRS Publication 590-B) had 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 had taken that position in official IRS publications, but the IRS took a different position in the proposed and final regulations. The final regulations retain the provisions in the proposed regulations, providing 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 (Reg. §1.401(a)(9)-5(d)(1)), and the full account must be distributed by December 31 of the tenth year after the year of death (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. Regs. §1.401(a)(9)-3(c)(3) & §1.401(a)(9)-3(c)(5)(i)(B).

Thus, whether the owner dies before the RBD or on or after the RBD is critically important under the 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. Reg. §1.408-8(b)(1)(ii).)

If the owner dies after the RBD and distributions must continue to be made annually, for the annual distribution in the calendar year after the year of the owner's death, the life expectancy of the DB would typically be used (assuming the beneficiary is younger than the deceased owner), and the life expectancy is determined initially using the beneficiary's age as of the birthday in the calendar year following the calendar year of the owner's death. Reg. §1.401(a)(9)-5(d)(3)(iii). (For example, if the beneficiary has a life expectancy of 30 years, 1/30th would be distributed in that first year, 1/29th in the next year, etc.)

As discussed above, the final regulations apply to distribution in years beginning in 2025. Therefore, the annual distribution requirement if the owner dies after the RBD does not apply until 2025. The anti-stretch provisions of the SECURE Act apply to owners who die in 2020 or later. IRS Notices have made clear that the failure to make such annual distributions in 2021-2024 will not cause the plan to fail to be a qualified plan, and the beneficiary who failed to take the distribution will not be liable for an excise tax. Notice 2022-53, 2022-45 IRB 437, Notice 2023-54, 2023-31 IRB 382, Notice 2024-35, 2024-19 IRB 1051. (The 2022 Notice (but not the 2023 and 2024 Notices) stated that if the taxpayer had already paid an excise tax for a missed distribution, the taxpayer may request a refund.) Footnote 11 of the preamble to the final regulations clarifies that make-up distributions are not required in 2025 for any such annual distributions that were not made in 2021-2024, but the 10-year deadline is still determined from the date of the participant's death. "For example, if an employee died in 2020, then in 2025, there are six years remaining in the 10-year period without regard to whether the designated beneficiary took distributions in 2021, 2022, 2023, or 2024. In 2030, the designated beneficiary must take a distribution of the remaining account balance." Preamble to Final Regulations, n.11. The annual payments for the remaining years are determined using the relevant life expectancy at participant's death and subtracting by one for each subsequent year in the "applicable denominator" (even though no distributions were required in those years between 2021-2024).

The IRS's rationale for the changed position requiring annual distributions during the 10-year term if the owner dies before the RBD was explained in the preamble to the proposed regulations. 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.)

The effect of the annual distribution requirement if the owner dies before the RBD with a DB as beneficiary 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).

The preamble to the proposed regulations gave 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. Proposed Regulations Preamble at 46-47.

(5) **Increased Ages for RBD of Owners.** The increased ages that were enacted in SECURE 2.0 for the RBD of an owner (discussed in Item14.d(1) below14.c(3)) are reflected in Reg. §1.401(a)(9)-2(b)(2).

(6) **Definition of "Child" Expanded.** The definition of "child" (for purposes of the minority EDB provision) is expanded to include "a stepchild, an adopted child, and an eligible foster child" (as explained in the preamble) by referencing §157(f)(1) in the definition. Reg. §1.401(a)(9)-4(e)(1)(ii).

(7) **Documentation Requirements for See-Through Trusts.** Certain documentation requirements apply for a see-through trust if the plan is to be treated as having DBs. The final regulations add that the plan administrator may determine which of two alternatives (providing a copy of the trust instrument or providing a list of beneficiaries) is available to an owner.

(8) **Charity as Remainder Beneficiary of Special Needs Trust.** The proposed regulations provided detailed provisions for "applicable multi-beneficiary trusts" that include a disabled or chronically ill individual as a beneficiary (thus qualifying as an EDB). Trusts for disabled persons are often drafted to include "special needs trust" provisions, and some people want to design special needs trusts to have a charity as the remainder beneficiary following the disabled person's death. The SECURE 2.0 Act amended §401(a)(9)(H)(v) to permit a charitable remainder beneficiary of a Type II applicable multi-beneficiary trust (AMBT). The final regulations reflect that change, but the final regulations delete the concept of "Type I" and "Type II" AMBTs. Reg. §1.401(a)(9)-4(g)(3).

(9) **Multiple Minor Beneficiaries of a Trust.** The proposed regulations provided that if a trust has multiple minor beneficiaries (i.e., have not reached age 21), the plan can be treated as having an EDB, and the final required distribution would not be until ten years after the *oldest* minor beneficiary reached age 21. The final regulations change this to provide that the final distribution would not be required until ten years after the *youngest* beneficiary reached age 21, or ten years after the last of the minor children dies. Reg. §1.401(a)(9)-5(f)(2)(ii)(C).

(10) **Separate Account Provision Applied to Trusts.** If the beneficiary designation provides that interests in a plan will pass to separate DBs, each of them are treated separately to determine the payout provisions to each. Under the proposed regulations, the separate account rule did not apply for a plan interest that passed to a trust, under which the plan interest would be allocated to separate trusts for specific individuals or would be distributed to specific individuals at the

owner's death. Instead, all the trust beneficiaries were generally counted for purposes of determining if the plan had a DB, and the oldest DB's life expectancy was used to determine the minimum annual distributions.

An important change in the final regulations is to apply the separate account rule to plan interests passing to a trust if the terms of that trust provide that it is to be divided immediately upon the death of the owner into separate shares for one or more trust beneficiaries, and the regulation provides details as to what "immediately divided" means:

> *Immediately divided defined.* For purposes of paragraph (a)(1)(iii)(B) of this section, a trust is immediately divided upon the death of the employee only if, as of the date of death, the trust is **terminated** and there is **no discretion** as to the extent to which of the separate trusts post-death distributions attributable to the employee's interest in the plan are allocated. A trust does not fail to be immediately divided upon the death of the employee merely because there are **administrative delays** between the date of the employee's death and the date on which the trust is divided and terminated, provided that any amounts received by the trust during this period are allocated as if the trust had been **divided** on the date of the employee's death.

Reg. §1.401(a)(9)-8(a)(iii)(C) (emphasis added).

A significant problem under this provision is that add it applies "only if the separate interests are held in separate see-through trusts." Reg. §1.401(a)(9)-8(a)(iii)(B). If the trust named as the beneficiary of the plan divides in a manner that at least some of the interests pass directly to individuals rather than remaining in further trusts, the provision would not apply. There is no policy reason for this distinction, but that is literally what the regulation requires. Conservative planners will not leave a plan interest outright to a single trust that divides at the owner's death unless it splits in its entirety into separate see-through trusts. Also, the trustee cannot be given discretion as to where the plan interests pass; they *must* pass into the designated sub-trusts in the proportions indicated.

(11) **Required Distribution In Year of Owner's Death May be Made to "Any" Beneficiary.** If the owner had reached the RBD before the date of death, distributions must be made each year, including in the year of death. If the required minimum distribution for that year has not been made to the owner before his or her death, the distribution must made at some point during that year after his death, and the final regulations clarify that the required distribution for that year may be made to "any" beneficiary ("as opposed to each of the beneficiaries being required to take a proportional share of the unpaid amount," as clarified in the preamble). Reg. §1.401(a)(9)-5(d)(1).

(12) **Beneficiary Younger Than Deceased Owner.** The distributions can be made over the greater of the life expectancy of the owner or the life expectancy of the DB (with the requirement that the full amount be distributed within ten years unless the beneficiary is an EDB). Reg. §1.401(a)(9)-5(d)(1)(ii). However, the proposed regulations had a provision stating that if the DB was younger than the owner, the entire plan interest would have to be distributed no later than when the owner would have reached his life expectancy (even though, up until that time, annual payments were being made over the life expectancy of the younger beneficiary). Prop. Reg. §1.401(a)(9)-5(e)(5). That provision was deleted from the final regulations, so the distributions can be made over the DB's full life expectancy (subject to the 10-year rule if the beneficiary is not an EDB).

d. **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.** A few of the added provisions are briefly summarized. More of the provisions are summarized in Item 4.i of Estate Planning Current Developments and Hot

Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

(3) **Some Topics Included.** A few of the topics include: (1) increased age for required beginning date for mandatory distributions (age 73 for those reaching age 72 after 2022 and age 74 for those reaching age 74 after 2032); (2) rollovers from 529 plans to Roth IRAs; (3) reduction in excise tax and statute of limitations for failure to take required minimum distributions; (4) IRA charitable rollovers (indexing of the $100,000 limit and allowing a rollover of up to $50,000 to a charitable remainder trust); (5) surviving spouse election for certain matters; (6) special needs trusts; and (7) conservation easements.

(4) **Notice 2024-2.** Guidance in the form of questions and answers regarding certain provisions in SECURE 2.0 was released December 20, 2023, in Notice 2024-2, 2024-2 I.R.B. 316 (dated January 8, 2024).

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

(6) **Proposed Regulations.** Proposed regulations regarding various provisions of SECURE 2.0 were issued on July 18, 2024 (and published in the Federal Register on July 19, 2024). In particular, detailed provisions are included regarding elections by a surviving spouse-beneficiary under §327 of SECURE 2.0.

17. Planning Section 501(c)(4) Organizations; "Patagonia Trusts"

Observations in this section are based on comments by Brad Bedingfield (Boston, Massachusetts).

a. **"Patagonia Trusts" and Other Notable Examples.** In 2022, Yvon Chouinard, the founder of clothing company Patagonia, conveyed 100% of the voting stock (2% of total shares) to a special purpose trust called the Patagonia Purpose Trust and contributed all the nonvoting stock to a section 501(c)(4) organization called the Holdfast Collective (which consisted of five trusts, with a private trust company serving as trustee of all the trusts). A focus of the nonprofit is to fight climate change. While the founder had to pay about $17.5 million of gift tax on the transfer of the voting shares to the special purpose trust, he did not have to pay any gift taxes or income taxes on the transfer of the $3 billion of nonvoting shares to the 501(c)(4) nonprofit. The Patagonia stock transfers received a great deal of public attention. David Gelles, *Billionaire No More: Patagonia Founder Gives Away the Company*, N. Y. TIMES (Sept. 14, 2022); *Patagonia founder's big donation potentially saves him over $1 billion in taxes – and experts say it shows how the wealthy are able to 'entirely opt out of taxes,'* BUSINESS INSIDER (September 16, 2022).

On the other end of the environmental political spectrum, Barre Seid gave all the shares of his company to the Marble Freedom Trust, a 501(c)(4) organization that opposes efforts to fight climate change, months before the company was sold by the nonprofit for $1.65 billion. Kenneth P. Vogel & Shane Goldmacher, *An Unusual $1.6 Billion Donation Bolsters Conservatives*, N.Y. TIMES (Aug. 22, 2022), **https://www.nytimes.com/2022/08/22/us/politics/republican-dark-money.html**.

Google co-founder Sergey Brin gave $366 million of appreciated Tesla stock to a section 501(c)(4) organization he created, named Catalyst4, to focus on health and climate change.

b. **Why the Transfers to 501(c)(4)s?; Potential Benefits.**

(3) **No Private Foundation Rules.** The gifts could have been made to private foundations, but some of the private foundation rules would be deal-breakers for these types of transfers, including the excess business holdings rule, the self-dealing rule, the 5% distribution requirement (imagine distributing 5% of $3 billion every year), and the 1.39% net investment income tax.

(4) **No Public Support Test Requirements.** If these founders had used a 501(c)(3) public charity to avoid the private foundation rules, they would have had to meet public support tests.

(5) **Broader Array of Permissible Activities.** Section 501(c)(4) organizations can engage in more types of activities than are permitted by 501(c)(3) organizations (including, among other things, some degree (how much is unclear) of political activities as well as unlimited lobbying activities (as long as the lobbying activities serve a "social welfare" purpose). Section 501(c)(3) organizations cannot participate in any partisan political candidate activity and are severely limited regarding lobbying.

(6) **Gift Tax is Not Applicable.** Section 2501(a)(6) provides that the gift tax does not apply to transfers to organizations described in §501(c)(4), (c)(5), or (c)(6). It was added by the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) following uncertainty regarding the application of the gift tax to gifts to 501(c)(4) organizations. (Observe: the gift tax is simply not applicable; it is not necessary to qualify for a gift tax charitable deduction under §2522, which has many restrictions and special rules [such as for partial interests or split interests].)

(7) **No Gain Realization on Appreciation.** There is no recognition of gain on the appreciation in the contributed assets. However, gain may be recognized if encumbered property is contributed to the organization. Those same rules also apply for gifts to private foundations or 501(c)(3) organizations, but unrealized gains are recognized for gifts made to §527 political organizations.

A bill has been introduced (the "End Tax Breaks for Dark Money Act") that would impose capital gains taxes on donations of appreciated property to §§501(c)(4), 501(c)(5), and 501(c)(6) organizations, to treat them the same as donations to §527 political organizations.

> "It's a clear sign of a broken tax code when a single donor can transfer assets worth $1.6 billion to a dark money political group without paying a penny in taxes, [Sheldon Whitehouse (D-RI), Senate Finance Committee member] said. "Billionaires attempting to influence politics from the shadows should not be rewarded with taxpayer subsidies."

Fred Stokeld, *Bill Goes After Tax Break for Billionaires' Dark Money Donations*, 182 TAX NOTES FEDERAL 1306 (Feb. 12, 2024).

(8) **Tax-Exempt Entity.** The 501(c)(4) organization is a tax-exempt entity; it is not subject to income tax except for the tax imposed on unrelated business taxable income (UBTI) and several other specialty taxes. Therefore, when the non-exempt organization sells the contributed asset (for $1.65 billion in the case of stock contributed several months earlier by Barry Seid to the Marble Freedom Trust), no capital gains tax is imposed on the entity.

(9) **Privacy.** For 501(c)(3) organizations, all donors are listed on the Schedule B (Schedule of Contributors) of the Form 990 that is filed annually with the IRS. That information is not made public, but some states have requested that the information be made public. Section 501(c)(4) organizations do not have to disclose a list of donors to the IRS or to the public. But if the organization is engaged in lobbying or political activities, other rules might require disclosure to the public. (Some families may view the lack of disclosure as a negative out of a concern that the organization might be viewed as being funded by "dark money." Others may welcome privacy as a protection from perceived harassment.)

c. **Overview of Concerns; Potential Disadvantages.**

(3) **No Income Tax Deduction for Contributions.** Contributions to 501(c)(4) organizations are not tax deductible for income tax purposes**.** (For very large contributions, the donor may not be able to use that much charitable deduction anyway.)

(4) **Reputational Concern.** Section 501(c)(4) organizations do many good things, but there have been reports in the news of (c)(4)s being used to hide abusive activities funded by "dark money." Philanthropic donors may be very sensitive to being perceived as being connected to such activities. Clients care more about reputational issues than tax considerations.

(5) **Lack of Control.** This is a very significant factor for some donors. Assets includible in the gross estate that are in a 501(c)(4) organization do not qualify for an estate tax charitable deduction. If a donor retains too much control, §2036(a)2) may cause the assets contributed to the 501(c)(4)

organization to be in the gross estate without an offsetting estate tax deduction. See Item 15.g(2) below for a discussion of planning alternatives around this issue.

(6) **Uncertainty.** There are no fixed rules about what "social welfare" activities are sufficient so the organization will be respected as a 501(c)(4) organization. Significant uncertainty exists as to how much political activities are permissible for a 501(c)(4) organization. Gift tax implications could be disastrous if the organization is later determined not to be a valid 501(c)(4) entity. (For that reason, donors of large gifts will want the organization to obtain an exempt status determination from the IRS before making the large gift.)

(7) **Future Law Changes?** A major advantage of using a Section 501(c)(4) organization instead of a private foundation is to avoid the private foundation excise tax rules. The law could change to impose some of those restrictions on 501(c)(4) organizations in the future.

d. **Gift Tax Considerations.**

(3) **Brief History.** Prior to 2015, whether gifts to a 501(c)(4) organization qualified for a gift tax charitable deduction was unclear. Gifts to political organizations described in §527(e)(1) are excluded from taxable gifts. §2501(a)(4). But Rev. Rul. 82-216, 1982-2 C.B. 220, states that a gift to an organization other than a political organization described in §527(e)(1) is subject to the gift tax, even if the transfer is motivated by a desire to advance the donor's own social, political, or charitable goals. The *Citizens United* Supreme Court case in 2010, providing that Congress could not restrict political expenditures for political campaigns, brought added attention to political campaign gifts. In 2010-2011, the IRS sent letters to various donors stating that contributions to a 501(c)(4) organization may be taxable gifts, and gift tax audits of gifts to (c)(4)s increased. Public pushback resulted, and the IRS in July 2011, issued a memo acknowledging that whether the gift tax applied to gifts to 501(c)(4) organizations was unclear and that until further notice, examination resources would not be devoted to the issue. Further political backlash arose from outcries that the IRS was weaponizing the gift tax against 501(c)(4) organizations.

(4) **Section 2501(a)(6).** All of that led to the enactment of §2501(a)(6) in the PATH Act of 2015, providing that the gift tax would not apply to contributions to 501(c)(4) organizations. This is a non-applicability provision, not just that a gift tax charitable deduction is available, so the detailed restrictions in §2522 (e.g., restrictions on gifts of partial interests and split interest gifts) do not apply.

(5) **Is It a Section 501(c)(4) Organization?** If a gift is made that does not satisfy the applicable charitable purposes under §501(c)(3) and if the organization ends up not being a valid 501(c)(4) entity, the gift tax would be triggered. Significant uncertainty can exist regarding whether the purposes of the organization qualify as appropriate "social welfare" purposes. Section 501(c)(4) organizations, unlike 501(c)(3) organizations, do not have to obtain a determination letter that the organization is an exempt entity, but they do have to notify the IRS within 60 days after formation of their intent to operate as a 501(c)(4) organization, and they can just start filing annual Form 990s. Alternatively, the (c)(4) organization can file Form 1024 to get a determination letter from the IRS that it is a valid (c)(4) exempt entity. Donors of large gifts will want the organization to obtain an exempt status determination letter from the IRS before making the large taxable gift.

e. **What Qualifies as a Section 501(c)(4) Organization?**

(3) **"Social Welfare Organization."** Section 501(c)(4) refers to organizations "operated exclusively for the promotion of social welfare." Whether a particular organization satisfies that nebulous "social welfare" requirement can be unclear. Regulations state that "[a]n organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community." Reg. §1.501(c)(4)-1(a)(2)(i).

IRS educational materials highlight the uncertainty that can exist about whether the "social welfare" purpose is met:

Although the Service has been making an effort to refine and clarify this area, Section 501(c)(4) remains in some degree a catchall for presumptively beneficial nonprofit organizations that resist classification under other exemption provisions of the Code. Unfortunately, this condition exists because social welfare is inherently an abstruse concept that continues to defy definitions.

Common themes of what qualifies are having an outward community focus and intent rather than an inward focus on private benefits. The key is benefitting the community as a whole and not a private subset of interests, including the private interests of the donor who created the organization.

Private inurement rules apply to both 501(c)(3) and (c)(4) organizations, and the organization can lose its 501(c)(4) exempt status if it funnels benefits to an insider. §501(c)(4)(B). In addition, private benefit rules apply, saying that no more than a certain amount of private benefit is permissible (and the rules for (c)(4)s are a little more lenient in that regard than for (c)(3)s).

(4) **Permissible Activities.**

(a) **Section 501(c)(3) Activities.** Activities that qualify under §501(c)(3) will also qualify for 501(c)(4) organizations.

(b) **No Charitable Class Requirement.** Unlike for 501(c)(3) organizations, there is no requirement of having an appropriate charitable class. Having a charitable class is not as important for educational or religious activities, but otherwise, having a recognized charitable class can be important for (c)(3) organizations. For example, a goal of assisting in providing low and moderate income housing would not qualify under (c)(3), but it would qualify as an acceptable activity for a 501(c)(4) organization if it was for the benefit of the community and serves a community goal. Another example is that supporting minority-owned businesses is probably not a valid (c)(3) activity where the activities are not targeted at the poor and needy or focused on education but could qualify under §501(c)(4) if intended as a community benefit.

(c) **Lobbying.** Lobbying is a permitted social welfare activity and can constitute 100% of the activities of the 501(c)(4) organization as long as the lobbying is for the community benefit and not just a private benefit (such as lobbying for zoning for one person). Reg. §1.501(c)(4)-1(a)(2)(ii).

(d) **Political Activities.** This is the hot button. This is the reason that may be a primary motivator for forming a 501(c)(4) organization. All the discussion and controversy leading up to the adoption of §2501(a)(6) focused on political activities. The regulations make clear that "[t]he promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office." Reg. §1.501(c)(4)-1(a)(2)(ii). *See* PLR 201221028. Section 501(c)(3) organizations cannot engage in any political activities. Some degree of political activity is allowed by (c)(4) entities. See Item 15.e(3) below regarding the amount of political activity that may be allowed.

(e) **Business Activities.** Similarly, an organization is not operated "primarily for the promotion of social welfare if its primary activity … is carrying on a business with the general public in a manner similar to organizations which are operated for profit." Reg. §1.501(c)(4)-1(a)(2)(ii). For example, an organization that operated a commercial resort and reinvested a large portion of its revenue in commercial operations was not entitled to 501(c)(4) exempt status even though it devoted some revenues to supporting social welfare activities. *People's Educational Camp Society, Inc. v. Commissioner*, 331 F.2d 923 (2d Cir. 1964).

For partnerships or LLCs taxed as partnerships, a look through rule applies: "the activities of an LLC treated as a partnership for federal income tax purposes are considered to be the activities of a nonprofit organization that is an owner of the LLC" for determining if it is "operated exclusively for exempt purposes…" Rev. Rul 98-15, 1998-1 C.B. 718.

The key is that the (c)(4) organization cannot just be a wrapper around an operating business. It must have community welfare activities (which could be just grantmaking).

(f) **Personal Interests of the Founder.** A 501(c)(4) organization must promote a community benefit, not just serve the founder's benefit. *See* PLR 201224034 (an organization established, funded and operated by a single individual (as sole member, director and president), without any community input or oversight and with no independent board members, was determined under the facts and circumstances, including connections with the founder's political interests, to be focused on primarily benefiting personal interests of the founder and not exempt under §501(c)(4)).

An organization with one person as founder and trustee may be a valid 501(c)(4) organization, but if the IRS is looking to take down a (c)(4) (for example, for a private benefit reason), it will use the fact that the entity had one person as donor and trustee to say the organization is all about the founder and not the community.

The best practice is to have some independence on the board of directors and not just have the organization run entirely by the founder-donor.

(5) **Quantum of Impermissible Activities (Including, Importantly, Political Activities) Allowed.** The regulations for (c)(3) and (c)(4) organizations both refer to **"primarily"** promoting the common good and general welfare of the community (for (c)(4)s) or the exempt purposes specified in §501(c)(3) (for (c)(3)s). But the regulation for (c)(3)s adds this sentence: "An organization will not be so regarded if more than an **insubstantial part** of its activities is not in furtherance of an exempt purpose." Reg. §1.501(c)(3)-1(c)(1); 1.501(c)(4)-1(a)(2)(i). Some viewed the distinction as meaning that up to 49% (i.e., not "primarily") of the activities of a (c)(4) but only up to 10-15% ("insubstantial") of the activities of a (c)(3) could be for impermissible activities. For decades, the additional sentence in the (c)(3) regulation seemed very important. *See* Rev. Rul. 75-286 (a 501(c)(4) organization can engage in substantial nonsocial welfare activities as long as they are not the primary activities).

Considerable lack of clarity prevails. Courts have applied in varying ways the meaning of the terms "exclusive," "primarily," and "insubstantial." A key issue is whether the political activities of a 501(c)(4) can be 49.9%, 40% or only 10-15% ("insubstantial). For about the last decade (until recently), the IRS has generally used a 40% threshold for political activities of (c)(4) organizations. See 2013 Letter 5228, Applicant Notification of Expedited 501(c)(4) Option (requiring representation that organization will spend 40% or less of time and expenditures on political campaign activities).

More recently, the IRS is taking a harsher position. In several cases, the IRS position has been that §501(c)(4) does not apply a lower standard than §501(c)(3) regarding determining if the exclusivity of exempt purposes test is met. *See Memorial Hermann Accountable Care Organization v. Commissioner*, T.C. Memo. 2023-62; *Freedom Path v. IRS*, Docket No 1:20-cv-01349 (D.C. Dist. Of Columbia).

Planning Tip: In light of those IRS positions, keeping political activities in the 10-15% range is safer (even though the published, and not withdrawn, Rev. Rul. 75-286 suggests that the "primary" test is applicable for (c)(4) organizations).

f. **Taxes Applicable to 501(c)(4) Organizations.**

(3) **Unrelated Business Taxable Income.** UBTI applies to 501(c)(4) organizations the same as for (c)(3) organizations (§511(a)-(b)), but the UBTI is reduced by distributions to charity to the extent allowed by §512(b)(10) or §512(b)(11).

(4) **Excess Benefit/Intermediate Sanctions, §4958.** Section 4958 applies to an organization that was a 501(c)(4) organization at the time of the transaction or during the prior five years. The more restrictive excess benefit rules that apply to donor advised funds and supporting organizations do not apply to 501(c)(4) organizations.

(5) **Excess Exempt Organization Executive Compensation, §4960.** The tax on excess executive compensation under §4960 applies to 501(c)(4), as well as (c)(3), organizations.

(6) **Political Activities Tax, §527(f).** The §527(f) political activity tax can be relevant for 501(c)(4) organizations that engage in substantial political activity. The corporate tax rate (21%) is imposed generally on the lesser of (1) amounts used for political activities (as described in §527) or (2) net investment income. For example, in one year the Patagonia Trust (c)(4) paid $275,000 of this tax (the taxed expenditures were making grants to political action committees engaged in political activities). The tax can be significant for organizations that have substantial income generating assets (producing interest, dividends, rents, and royalties) and political activities. The tax can be minimized by establishing a separate segregated fund tor engaging in political activities. §527(f)(3).

g. **Tax Pitfalls.**

(3) **Gift Tax.** Transfers to the organization will be subject to gift tax if the organization ultimately is determined not to be a valid 501(c)(3) or (c)(4) entity. Donors of large gifts will insist that the organization obtain a determination letter before making large gifts to the organization. See Item 15.d(3) above.

(4) **Estate Tax.** The big tax trap is the estate tax. (It is the reason that using a 501(c)(4) organization is not acceptable to many donors.) If the donor keeps control that triggers §2036(a)(2), the assets of the organization attributable to the donor's contribution will be included in the donor's gross estate. Serving as a director or officer of the organization will likely cause estate inclusion. *See* Rev. Rul. 72-552 (value of property the decedent transferred to a §501(c)(3) corporation is includible in the gross estate under §2036 if the decedent served as a member, director or president of the corporation, and had the power, alone or with others, to direct the disposition of the corporation's funds for charitable purposes); *Rifkind v. U.S.*, 54 AFTR 2d 84-6453 (Cl. Ct. 1984) (assets of charitable lead annuity trust may be included in donor's gross estate if the annuity is paid to a foundation of which the donor was one of three directors; resigning within three years of death may result in inclusion in the gross estate under §2035).

Inclusion of the (c)(4)'s assets in the donor's gross estate would be disastrous from an estate tax standpoint because no estate tax charitable deduction is available for amounts passing to or in 501(c)(4) organizations that are included the donor's gross estate.

Two solutions are available.

(1) **Relinquish All Control.** Limit the involvement of the donor in the organization's activities sufficient to avoid triggering §2036(a)(2), such as avoiding serving as a director, trustee, or officer of the organization. (The trustee of the trusts that constitute the Patagonia founder's 501(c)(4) organization is a private trust company. Presumably, it is designed to avoid estate inclusion for the donor under §2036(a)(2). Otherwise, the estate tax bill would be in the hundreds of millions of dollars.) Avoiding estate inclusion may be possible with strategies commonly used to avoid §2036(a)(2). These include: (1) avoid holding any position that participates in distribution decisions, (2) limit the donor's power to investment and management, not distribution, decisions; (3) limit any ability to appoint and remove directors or trustees to the appointment of independent directors and trustees; and (4) make sure the donor could never be appointed to a position holding such a tax sensitive power.

(2) **Convert to 501(c)(3) at Death.** The other alternative is to provide that the organization would at the donor's death convert to an organization "operated exclusively for … charitable" purposes under §2055, meaning that it would be converted to a private foundation or 501(c)(3) organization at the donor's death. A similar approach, instead of auto-converting at the donor's death, is to provide that if assets of the organization are included in the donor's gross estate, the assets would thereafter be devoted exclusively to charitable purposes consistent with §2055 (either by giving them to another charity or creating a new charity to hold them). Assets of the organization that are included in the donor's gross estate would then qualify for an offsetting estate tax charitable deduction.

A potential concern is that assets of the (c)(4) organization may be aggregated with other assets in the gross estate for valuation purposes. For example, if the (c)(4) organization owned

nonvoting stock and the decedent owned voting stock of the same corporation, the value of the nonvoting stock may be increased because of the voting control, but the charitable deduction may be limited to the value of the nonvoting stock without any voting control attributes. *See Estate of Warne v. Commissioner*, T.C. Memo. 2021-17.

h. **Situations in Which Section 501(c)(4) Planning Is Workable.**

(3) **No Accumulation of Assets.** Use assets as they are contributed to the organization, and do not accumulate significant assets in the organization. There would not be much value to include in the estate under §2036 in any event, so the donor can keep the desired control over the organization (subject to the wisdom of still having some independent director or outside input to help assure it will be recognized as a valid (c)(4) organization serving community benefit).

(4) **Donor Willing to Relinquish Control.** This is the Patagonia Trust situation. The donor was willing to relinquish all control to a private trust company as trustee to avoid the estate tax trap.

(5) **Temporary (c)(4) Organization.** The donor is willing to convert the organization to a private foundation or 501(c)(3) organization at the donor's death.

(6) **Often Not Appropriate.** Mr. Bedingfield practices exclusively in the charitable planning/charitable organizations area. He said that that he has created 501(c)(4) organizations in only a few situations. Either none of the three situations described above is appropriate, or the donor is concerned with reputational risk that may be result from being connected with a 501(c)(4) organization.

i. **Resource.** For further discussion of planning issues with 501(c)(4) organizations see Alan Gassman, Karl Mill & Peter Farrell, *The 501(c)(4) Strategy*, 48 BLOOMBERG TAX MGMT. ESTS., GIFTS & TRUSTS J. No. 1 (Jan. 12, 2023).

18. Below-Market Loans From Trusts

a. **Rent-Free Use of Trust Assets.** Merely allowing a beneficiary to use trust assets, even if the trust pays property taxes or maintains the asset, is not a distribution that carries out DNI to the beneficiary. *DuPont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976), *aff'd*, 574 F.2d 1332 (5th Cir. 1978); *Commissioner v. Plant*, 76 F.2d 8 (2d Cir. 1935), *acq*. 1976-1 C.B. 1; Ltr. Rul. 8341005.

b. **Below-Market Loans from Trusts.** Analogous to rent-free use of assets is "rent-free" use of money, i.e., an interest-free loan. As with rent-free use of assets, various reasons may support a fiduciary's decision to make below-market or interest-free loans to a beneficiary rather than making distributions to the beneficiary. How are below-market loans from trusts treated for tax purposes?

(3) **Section 7872.** While §7872 provides for imputed interest on interest-free loans, cogent arguments exist that interest-free loans to a beneficiary from an estate or trust may not be subject to §7872.

(a) **Gift Loans.** For gift loans or demand loans, the forgone interest is treated as transferred from the lender to the borrower [as a gift] and retransferred by the borrower to the lender [as interest income]. §7872(a)(1). Arguably, however, an interest-free loan from an estate or trust is not a "gift loan" under §7872 because estates and trusts cannot make gifts (which raises the point that the fiduciary must have the authority and a reason within the exercise of the fiduciary's discretion for making the interest-free loan to a beneficiary in a particular situation).

(b) **"Significant Effect" Loans.** While §7872(c)(1)(e) authorizes regulations applying §7872 to situations not otherwise subject to §7872 that have a "significant effect" on the federal tax liability of the borrower or lender, no such regulations have been issued, and proposed regulations do not exercise this power. Preamble to Prop. Regs., 50 Fed. Reg. at 33554 (Aug. 20, 1985) (no "significant effect loan" treatment earlier than the date future regulations under §7872(c)(1)(e) are proposed).

(c) **"Tax Avoidance" Loans.** In a particular circumstance, an interest-free loan may not be a "tax avoidance loan" under §7872(c)(1)(D) because the beneficiary may have the imputed interest

carried out to her as a DNI distribution, and the loan proceeds may be used for a purpose such that the interest would be deductible by the beneficiary and therefore offset the income, or the fiduciary may have a purpose for making the interest-free loan independent of tax consequences.

(4) **Original Issue Discount.** An interest-free loan for money does not result in original issue discount (OID) to be included in income.

(a) **Section 1273.** Under §1273(a)(1) OID is (1) the stated redemption price at maturity over (2) the issue price.

Under §1273(a)(2) the "stated redemption price at maturity" is the total payments under the note, less any qualified interest payments (fixed rate, payable unconditionally at fixed periodic intervals of 1 year or less over the entire term of the note). Thus, for an interest-free note, the stated redemption price at maturity is the amount of the note.

The "issue price" for a money loan is the initial loan amount. §1273(b)(2). Section 1273(b)(2) is not that direct regarding money loans, but that is the effect of §1273(b)(2). Reg. §1.1273-2(a)(1) is more direct in saying that in the case of a loan for money, "the issue price of the instrument is the amount loaned."

Accordingly, for an interest-free loan, the stated redemption price at maturity is the same as the issue price, so no OID results under §1273.

(b) **Section 7872.** OID can also result under §7872. For below market loans (other than gift loans or demand loans) to which §7872 applies, the difference between the amount loaned and the present value of payment under the loan is treated as OID. §7872(b)(2)(A). But §7872 does not apply (i.e., if none of the loans listed in §7872(c) are applicable, as described above) no OID is created under §7872(b)(2)(A).

c. **Resources.** These arguments are explored in Cundiff & Ose, *Unpack the Potential of the Trust to Beneficiary Interest-Free Loan*, TRUSTS & ESTATES 22 (June 2023).

19. Distribution Standard Based on Accustomed Standard of Living, *In the Matter of Katherine E. Reece Trust v. Reece,* 2023 WL 6300306 (Colo. Ct. App. 2023)

If a trust distribution standard (for example, for the beneficiary's health, support, and maintenance) is accompanied by a reference to maintaining a beneficiary's "accustomed standard of living," when should that standard of living be determined? That was the issue in *In the Matter of Katherine E. Reece Trust v. Reece*, 2023 WL 6300306 (Colo. Ct. App. 2023).

Frascona Reece signed a will in 2011that created the Katherine E. Reece Trust for the benefit of his wife, Katherine, if she survived him. Katherine and Frascona's two children from his first marriage are beneficiaries. The trustee may distribute to Katherine and Frascona's descendants amounts needed for their health, education, support, and maintenance, giving primary consideration to the needs of Katherine and secondary consideration to the needs of his descendants. The trust agreement included the following provision: "… I suggest to [the] trustee that the primary purposes [of the trust] are to provide for my spouse's support, having regard to my spouse's other means of support and *the standard of living enjoyed by my spouse during our marriage*…"

Frascona and Katherine separated two years after he executed the will. A decree of legal separation was entered, incorporating a legal separation agreement providing that the marriage could not be dissolved for almost a year and providing that she would remain a beneficiary of the trust until the marriage was dissolved by divorce. One day before that period ended, Frascona died in an airplane crash. Thus, Katherine was married to him at his death and remained a trust beneficiary.

Katherine's standard of living declined "markedly" during the period of separation, and the trustee sought instructions from the court regarding how to measure "the standard of living enjoyed by Ms. Reece during our marriage…"

Is the standard of living determined from time to time (as affected by trust distributions) or at a fixed point in time (the date of the testator's death)? In determining the testator's intent, the court looked to the position of the RESTATEMENT (THIRD) OF TRUSTS, Comment d(2). It provides: "[t]he accustomed manner of living for … purposes [of support and maintenance] is ordinarily that enjoyed by the beneficiary at the time of the settlor's death or at the time an irrevocable trust is created." The court stated that it found no other cases applying that rule to measure a beneficiary's standard of living in the same context but concluded that "the Restatement's rule is appropriate to determine Katherine's standard of living under the circumstances of this case." Therefore, Katherine's lower standard of living at the time of Frascona's death was the appropriate distribution standard.

This issue is not addressed in many trust agreements. The drafter should consider whether, in appropriate circumstances, the settlor's intent as to this issue should be made clear.

20. IRS Position Refusing to Respect Decanting and Denying Estate Tax Charitable Deduction Even Though Assets Were Actually Appointed to Charity Rejected by Tax Court, *Estate of Horvitz v. Commissioner,* T.C. Dkt. No. 20409-19 (Order dated Feb. 7, 2023)

a. **Synopsis and Basic Facts.** QTIP trusts, funded when the predeceased spouse died in 1992, were decanted in 2013 to trusts with a broadened testamentary power of appointment (that could be exercised by a signed written instrument taking effect at the surviving spouse's death) allowing the surviving spouse to appoint the assets to charity. The surviving spouse died in 2015 having appointed about $20 million to charities and her estate claimed an estate tax charitable deduction. The IRS took the position that the decanting was not appropriate, that the assets did not properly pass to the charities, and that no estate tax charitable deduction was allowed.

The Ohio decanting statute allows decanting to another trust if the trust agreement gives the trustee "absolute" authority to make principal distributions, which is defined as distributions that are not subject to an ascertainable standard. OHIO REV. CODE §5808.18(A)(1) & (2)(a). The decanted trust can include a broadened power of appointment that includes additional potential appointees.

The original QTIP trusts had various clauses that supported the legitimacy of the decanting. The distribution standard permitted distributions for the beneficiary's "comfort or general welfare" and included within that standard were distributions that "serve estate or tax planning objectives" and transfers deemed to be in "the best interests of the beneficiary." The original trust agreement included a decanting authority, stating that any authority to make distributions to a beneficiary includes authority to "to pay principal to a trust for the benefit of the beneficiary." Despite those provisions, the IRS position was that the trustee of the original QTIP trusts had no authority to decant the assets to the second trusts.

Discovery disputes arose in the Tax Court litigation over whether certain requested information was relevant and whether it was protected from discovery by the attorney-client privilege and attorney work product doctrine. Eventually (on October 14, 2021), the estate filed a motion for summary judgment asking the court to determine that the estate tax charitable deduction was allowed, claiming that the validity of the applicability of the charitable deduction was a legal issue with no material facts in dispute. The IRS (on January 7, 2022) filed a motion to compel compliance with discovery requests and an opposition to the estate's motion for summary judgment.

Thirteen months later (on February 7, 2023) the court entered an Order generally agreeing with the estate's legal positions – factual testimony about whether the Trustee believed the decanting was permissible would not affect the outcome; even if the decanting was impermissible, no contest was asserted as to the decanting or the contributions to charities and the court knows of no authority permitting the IRS to collaterally attack the charitable contributions; the distribution standard was not an ascertainable standard; and the Order had no discussion suggesting uncertainty about whether the decanting transaction was permissible. The Order directed counsel for the parties to confer with one another within one week to consider settling the case in light of observations in the Order. *Estate of Horvitz v. Commissioner*, T.C. Dkt. No. 20409-19 (Petition filed Nov. 15, 2019; Order dated Feb. 7, 2023, Judge Gustafson).

Within that one-week period, the IRS agreed to allow a full estate tax charitable deduction for the assets that passed to charities pursuant to the exercise of the power of appointment under the decanted trust. A Stipulation of Settled Issues was filed within about two weeks, and a Stipulated Decision was entered almost two months later (on April 6, 2023) – 8 years after the decedent's death.

b. **Observations.**

(3) **IRS's and Court's Reactions to Decanting.** The IRS was reluctant to allow an estate tax charitable deduction for charitable contributions that were made under the broadened power of appointment as a result of a decanting transaction. (It is rather surprising that the IRS chose to raise its objections to allowing an estate tax charitable deduction under a decanting transaction in a case in which about $20 million actually passed to charities.) The judge expressed no hostility to the decanting transaction or to recognizing it for tax purposes. The IRS eventually conceded (and the taxpayer had good facts in the case to support the decanting authority).

Planners may experience similar IRS hostility in the future to broadened distribution authority granted in decanting transactions (for example, assets in a non-exempt trust might be decanted to a new trust giving someone a power of appointment to appoint assets to a non-skip person, who could engage in further estate planning transfers to minimize tax costs of passing assets to younger generations). Distributions pursuant to a broad authority to make distributions or a broad power of appointment rather than having to use a decanting transaction may be safer.

(4) **Significant Expense.** The dispute about the availability of an estate tax deduction for about $20 million that actually passed to charities took 8 years after the decedent's death and about 3½ years after the filing of a Tax Court petition to resolve. The litigation involved discovery disputes over "several thousand documents." The estate incurred significant litigation costs.

(5) **Recognition of Prior Transfers That Have Been Uncontested.** A paragraph in the Order questioned whether the IRS could contest the availability of a charitable deduction in a situation in which no one had complained about the decanting, the statute of limitations had passed on the ability to contest the transaction, and money had actually passed to charities. This argument is reminiscent of Revenue Ruling 73-142, 1973-1 C.B. 405, which addressed the tax effects of transfers pursuant to court construction actions that had become final and binding before a taxable event, even if the construction was improper. In Revenue Ruling 73-142, the state court determination, which was binding on everyone in the world after the appropriate appeals periods ran, occurred before the taxable event, which would have been the settlor's death. The IRS agreed that it was bound by the court's ruling as well, "regardless of how erroneous the court's application of the state law may have been."

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

(6) **Contrast with Trust Charitable Income Tax Deduction.** A trust is entitled to a charitable income tax deduction for amounts of gross income passing to charity "pursuant to the terms of the governing instrument." §642(c)(1). However, no governing instrument requirement applies for the estate tax charitable deduction. That difference is another reason that the IRS's reluctance to allow an estate tax charitable deduction for assets passing pursuant to provisions in a decanted trust is so puzzling.

Chief Counsel Advice in 2016 and 2017 concluded that assets appointed to charities under a power of appointment granted in a court modification would not satisfy the "pursuant to the terms of the governing instrument" requirement. CCA 201747005 (includes extended discussion of *Bosch* and Rev. Rul. 73-142); CCA 201651013.

This conclusion seems incorrect; if the governing instrument is effectively modified under state law before the transfer to charity, subsequent transfers would seem to be made pursuant to the terms of the governing instrument in the absence of guidance under §642(c) that it looks only to

the governing instrument as originally executed, without valid modifications. The case involved with the 2016 and 2017 CCAs was subsequently settled.

(7) **Further Discussion.** For further discussion of *Horvitz*, see Item 25 of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

21. Tax Affecting for Valuing an S Corporation Recognized When Used by All Experts in the Case But Is Not Always (or Even Usually) Proper, Marketability Discounts for Different Block Sizes of Stock, Zero Weight Given to Asset Value in Valuing Ongoing Business, *Estate of Cecil v. Commissioner*, T.C. Memo. 2023-24

a. **Synopsis.** In 2010, William Cecil, Sr. (grandson of George W. Vanderbilt who built the famed Vanderbilt Biltmore House in Asheville, North Carolina between 1889 and 1895) and his wife gave stock (and made the split gift election) in an S corporation that owned the Biltmore House and some of the surrounding land, an Inn, and other tourist facilities. (The Biltmore House, with its four acres of floorspace, remains the largest privately owned house in the United States.)

Over the years, the Cecil family has been through three gift tax audits: (1) 1999; (2) 2005-2006; and (3) 2010 (the gift tax audit resulting in this case). In 1999, the donors and IRS agreed on an earnings/asset hybrid valuation formula. In the 2005-2006 audit, the IRS initially rejected that approach but ultimately agreed to use the same approach.

In the 2010 gift transactions, voting stock (one of seven shares of voting stock, representing 14.29% of the voting stock) was given to the donors' two children (Bill Cecil and Dini Pickering) and nonvoting stock was given to their five grandchildren. Bill Cecil's three children each received 15.57% of the nonvoting stock and Dini Pickering's two children each received 23.36% of the nonvoting stock. (The donors' two children are both very active in the company; Bill Cecil is the president and CEO and Dini Pickering is vice chairman of the board of directors and has worked for the company for over 30 years.) The S corporation's assets were used to generate earnings, producing about $70 million of revenue in 2010 ($38.4 million of that coming from admission tickets). The company reported assets and liabilities of about $53.6 million and $33.3 million, respectively, or a net of $20.2 million. The company operated at least 17 lines of business and employed 1,304 employees ("over 1,800 combined full-time and parti-time employees including associated businesses").

The donors attached an appraisal to the gift tax return (using a weighted average of value under an asset approach valuing the company based on the fair market value of its net assets and an income approach valuing the company based on the present value of its estimated future cashflow, in effect its ability to produce income) reporting a value of $3,308 per share of voting stock and $2,236 per share of nonvoting stock, for gifts by each donor of about $10.44 million. The donors used the same settlement formula that was agreed to by the IRS in the 1999 and 2005-2006 gift tax audits. The IRS rejected that approach and valued the stock solely using an asset approach and claiming that the ongoing business operation had no economic substance. The IRS came up with a **much** larger value of the gifts, asserting a gift tax deficiency of about $13.1 million by each donor, or over $26 million. Both donors subsequently died prior to the resolution of the 2010 gift tax audit and were substituted in the gift tax case by their coexecutor Bill Cecil.

At trial, donors presented two experts (neither of which prepared the appraisal attached to the gift tax return). Both used the income and market methods of valuation (not the asset method), and both used tax affecting to adjust for the fact that their analyses used capitalization and discount rates based on data for C corporations (presumably publicly traded companies), whereas the S corporation's income was before-tax cashflow. Both of the donors' experts said the values under the 1999 and 2005-2006 settlement formulas were too high, and the donors thereby asserted that they were entitled to a substantial refund of gift tax paid.

Shortly before trial (on the 30-days-before-trial deadline for offering valuation opinions) the IRS backed off substantially by offering their expert's appraisal that gave only a 10% (down from 100%) weighting to the asset value approach, reducing the alleged deficiency to $3 million (down from $26

million!). The IRS used one appraiser to appraise artwork owned by the corporation (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 that appraiser also used tax affecting under the income approach analysis).

The taxpayer's opening brief commented on the extreme "stubborn" position that had been taken by the IRS throughout the audit:

> With interest through the trial date, the total demand exceeded $30 million. Respondent left this 84 and 87 year-old couple living with that Sword of Damocles swinging over their heads for nearly two years.
>
> Despite knowing his Notice lacked any rational basis, Respondent stubbornly refused to concede "economic substance" in his Answer, his informal responses, his formal discovery responses, and various motions. For the first time 30 days prior to trial, he tendered an appraisal proving his Notices overstated the tax by at least $22,989,798. Even though he adopted that valuation in his trial memorandum, he never amended his pleadings or admitted he overstated his claims by 90 percent. To this day, he will not concede the words "economic substance" in writing.

The gifts were made in November 2010, the Tax Court trial was held February 25-26, 2016 **(seven years ago!),** and the briefing was completed in July 2016. Based on the long delay, many planners (and probably the attorneys representing the taxpayers) assumed this case might result in an opinion reviewed by the full Tax Court with a detailed analysis of the court's approach to tax affecting. Not so. The opinion devoted only about two pages to its tax affecting analysis.

The court noted that beginning with the *Gross v. Commissioner* Tax Court case in 1999, the court has generally held that tax affecting is not appropriate for valuing S corporations, citing various subsequent cases that have rejected using tax affecting (including, for example, *Estate of Gallagher*, *Dallas*, *Wall*, and *Estate of Giustina*) The court discussed two more recent cases, one of which (*Estate of Jones*) allowed tax affecting in part because the IRS's expert was largely silent about tax affecting other than to disagree with the way taxpayer's expert had applied it, and the other (*Estate of Jackson*) rejected a tax affecting analysis based on an assumption that buyers would be C corporations, but the court was not persuaded of that. Because all the experts in the *Cecil* case (other than the art expert), including the IRS's expert, agreed that tax affecting was appropriate and one of the taxpayers' experts and the IRS expert agreed on the appropriate tax affecting analysis, the court concluded the circumstances "require our application of tax affecting." The court made very clear, however, that it was sanctioning the use of tax affecting generally with this important caveat: "We emphasize, however, that while we are applying tax affecting here, given the unique setting at hand, we are not necessarily holding that tax affecting is always, or even more often than not, a proper consideration for valuing an S corporation."

The court analyzed the reports from the various experts. The court assigned "zero weight" to the IRS expert because it used an asset-based approach even though liquidation was "most unlikely" (without commenting on the fact the appraiser assigned merely a 10% weight to its asset-based approach and without noting that it actually *did* apply parts of that expert's analysis). Assigning a **zero weight to the asset-based approach** was very significant because of the dramatic difference between the ongoing concern value and the asset value of the business—reportedly **roughly $15 million vs. $147 million** (the total asset value as determined by the IRS's valuation expert). The court adopted the IRS's expert's 17.6% rate for applying the tax affecting analysis. The court found flaws in both of the taxpayers' experts reports as well but used one of the reports as "the truest value of the subject stock's prediscount fair market value" (but applying a different rate for the tax affecting analysis). The court adjusted the lack of control and marketability discounts, applying both a **20% lack of control discount** (used by one of the taxpayer's experts) and **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).

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,

suggesting that the taxpayers may be entitled to a substantial gift tax refund. *Estate of Cecil v. Commissioner*, T.C. Memo. 2023-24 (February 28, 2023, Judge Ashford).

b. **Overview of Valuation Approaches.** The opinion provides a helpful overview of three general approaches used for valuing assets.

(3) **Market Approach.** The market approach values property by considering the sale prices of substantially similar comparable properties and adjusting to account for differences between the subject property and the comparable properties.

(4) **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.

(5) **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.** For a summary of the experts' reports see Item 28.c of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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.)

(3) **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, and even the IRS's expert agreed, that tax affecting should be applied), and 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)

(4) **Further Discussion.** For further discussion of the core justifications of tax affecting, prior internal IRS guidance, *Gross v. Commissioner*, *Gallagher v. Commissioner*, *Kress v. United States*, *Estate of Jones v. Commissioner*, *Estate of Michael Jackson v. Commissioner*, and planning considerations in make a tax affecting argument, see Item 28.d(2)-(10) of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

e. **Asset Value vs. Ongoing Concern Value; Planning Considerations.** In *Cecil*, there was a dramatic difference between the ongoing concern value and the asset value of the business—reportedly **roughly $15 million vs. $147 million** (the total asset value as determined by the IRS's valuation expert). The donors initially reported gift values on their gift tax returns giving some weight to the asset values. The IRS reportedly kept increasing the weighting that should be applied to the asset value approach in negotiations, and eventually assessed a $13 million gift tax deficiency by each of the donor-spouses. The donors filed a petition with the Tax Court taking the position that zero weight should be given to the asset value and that they should be entitled to a refund. This is a classic case where the net asset value of an entity is far far greater than its value as an ongoing business.

The IRS's appraiser determined that the total net asset value of the entity was $146,587,000, reflecting increases in value that included $95,922,000 with respect to real estate, $41,421,000 with respect to art, antiques, and other collectibles, $2,700,000 with respect to an installment note receivable, $9,514,000 with respect to trademarks and trade name, and $1,624,000 with respect to workforce-in-place.

The IRS's appraiser reduced that net asset value to $92 million on a "noncontrolling but marketable and liquid basis," and gave only a 10% weighting to the net asset value in his valuation of the company because the company "does not seek to maximize its assets."

The donors' two experts gave the company's asset value a zero weighting, instead using the market and income approaches. Observe the dramatic valuation difference based on valuing the company merely on its value as an ongoing operating company vs. its liquidation value.

The court agreed that the asset value should be given a **ZERO** weighting in valuing the company. The court pointed to various reasons.

- Cases, citing *Estate of Ford v. Commissioner*, T.C. Memo. 1993-580, *aff'd*, 53 F.3d 924 (8th Cir. 1995) ("[P]rimary consideration is generally given to earnings in valuing the stock of an operating company, while asset values are generally accorded the greatest weight in valuing the stock of a holding company."). Other cases (not cited for this issue in *Cecil*) have valued operating companies based entirely on the income method. *E.g.*, *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101 (timber is valued under the income method rather than the net asset value method in this situation where there is an ongoing business operation and the facts are clear that the timber will not be liquidated and the transferee would have no ability to force the liquidation); *Estate of Giustina v. Commissioner*, 586 F. App'x 417, 418 (9th Cir. 2014) (holding that no weight should be given to an asset-based valuation because the assumption of an asset sale was a hypothetical scenario contrary to the evidence in the record), *rev'g and remanding* T.C. Memo. 2011-141.
- Uniform Standards of Professional Appraisal Practice (USPAP) Standards Rule 9-3, which states:

  In developing an appraisal of an equity interest in a business enterprise with the ability to cause liquidation, an appraiser must investigate the possibility that the business enterprise may have a higher value by liquidation of all or a part of the enterprise. . . . However, this typically applies only when the business equity being appraised is in a position to cause liquidation.

The court observed, "That is not the setting here."

- Liquidation is most unlikely.
    - A hypothetical buyer would be unlikely to acquire enough shares to force liquidation, convince other shareholders to vote for liquidation, or wait until shareholders decide to liquidate.
    - The family members who own the company's shares all testified that they had no intention of selling their stock or liquidating the company.
    - The court refused the IRS's request to disregard that testimony as self-serving, because the court found their testimony credible and because documentary and other evidence supports that testimony.
- Documentary and other evidence supporting the unlikelihood of a liquidation was summarized by the court:

    > The 2009 Shareholders' Agreement and the 1999 Voting Trust sufficiently established that petitioners, their children, and their grandchildren aspired to keep TBC in their family by restricting the transfer of stock outside of the family. We also understand the family's holding of the annual meetings to serve strategically to minimize and control business disputes that could occur within the family, to obviate any TBC shareholder's rogue attempt to sell his or her TBC shares to an outsider, and to make most unlikely any breakup of TBC similar to the breakup effected by Mr. Cecil and his brother in 1979. These meetings also serve to groom TBC's shareholders to manage TBC as a family asset. The fact that TBC has been in the family since its incorporation in 1932 also speaks loudly to the fact that the Cecil and the Pickering families are committed to maintaining TBC as a family business.

- Having a formal succession plan and a plan for continuing the ongoing operation of the company, with consistent repeated documentary evidence of that plan, can be very important to convincing a court that little (or no) weight should be given to the liquidation value of the company assets. Tax litigators point out that the Tax Court places an obsessive emphasis on documentation. Some say "undocumented testimony is almost worthless. Whatever the issue is, get it formalized in documents."

f. **Extended Case Arising From IRS's Extreme Valuation Position.** The extended gift tax audit arose from the IRS's insistence on valuing the business solely based on the value of its assets despite the fact it was a large ongoing business operation. The IRS backed off that position substantially a mere 30 days before trial. A commentator has roundly criticized the unfairness of this situation, noting perceived failures by the IRS, IRS Appeals, and the Tax Court.

> I'm **gobsmacked-appalled-outraged**-about this case.
>
> …
>
> In short, ladies and gentlemen, we have a tax system that, at least at present, only effectively exists due to ***voluntary compliance*** by the overwhelming majority of taxpayers. But the system, including the IRS and the Tax Court, ***must work fairly and efficiently in order to give taxpayers confidence to voluntarily comply.***
>
> Make no mistake: **our tax system failed the Cecils.**
>
> …
>
> But in the 2010 gift tax audit, ***despite no changes in the Company's business operations or the family's clear desire to continue the Company's business (with mountainous supporting evidence-how many companies have you heard of with 300 YEAR plans?) since the 2005-2006 gift tax audits,*** the IRS gift tax auditor didn't feel bound by the settlement valuation formula to which the IRS had agreed in three prior gift tax audits of gifts in four separate taxable years, in favor of ***completely disregarding the Company's existence altogether as "lacking economic substance,"*** and the IRS valued the shares of Company stock using an *asset liquidation* approach. The result? A deficiency notice valuation resulting in a number ***four to five times the per share values of the 2010 gifts,*** which had been valued based on the previously agreed-to IRS settlement valuation formula.
>
> …

… The undeniable effect of allowing the IRS to take such an outrageous, flimsy case to trial essentially is the ***flipside of the allegations from the IRS that taxpayers are playing the "audit lottery" and as equally reprehensible.***

Three audits (gift tax returns for four different calendar years involved) in less than 12 years? I don't think that the word ***"shakedown"*** is an unfair word to say. [The writer described an overly aggressive agent in another situation], but IRS Appeals curbed his excessive exuberance, which, frankly, is what should've happened here***. In my opinion, this case should've never left IRS Appeals.***

…

… Make no mistake: if the IRS is allowed to take cases that aren't supported by admissible expert witness evidence to trial, ***the unmistakable effect is the IRS flipside of taxpayers playing the "audit lottery," forcing taxpayers to either litigate or settle based on sheer size of the deficiency, which erodes taxpayer confidence in our predominantly voluntary tax system, and, as such, equally reprehensible as the audit lottery.***

Why did it take 2,558 days (more than ***seven years*** between trial and rendered decision/decision) to decide this case? That's a fair question, especially given that the case docket report reveals nothing apparent going on in the interim, especially given the slam-dunk taxpayer victory this case was?

…

Conclusion

Houston, we have a problem. Steps must be taken to ensure that this never happens again.

Paul Hood, *Estate of Cecil v. Commissioner: Appalling IRS Valuation Shakedown Effort Averted in the Tax Court, Finally!*, LEIMBERG ESTATE PLANNING NEWSLETTER #3063 (September 7, 2023) (emphasis in original).

22. Application of Anticipatory Assignment of Income Doctrine and Availability of Charitable Deduction; Recent Cases Involving Gifts to Charity Followed Quickly by Sale, *Hoensheid v. Commissioner*, T.C. Memo. 2023-34, *Keefer v. United States., Dickinson v. Commissioner*, 130 AFTR 2d 2022-5002 (July 6, 2022) 130 AFTR 2d 2022-5405 (N.D. Tex. August 10, 2022) (denying motion for reconsideration)

a. **Overview.** Three cases in the last several years have provided insight to when the anticipatory assignment of income doctrine will apply when a gift of shares is made to charity that are sold by the charity soon after the contribution. One case allowed the donor to avoid recognition of gain (*Dickinson v. Commissioner*) but the other two (*Keefer v. United States* and *Hoensheid v. Commissioner)* held that the anticipatory assignment of income doctrine applied causing 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). The most recent of these three cases, *Hoensheid*, is discussed below. The other two are referenced briefly.

b. **Assignment of Income Applied and Charitable Deduction Denied, *Estate of Hoensheid v. Commissioner*, T.C. Memo. 2023-34.**

(3) **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, the day the DAF received the stock certificate by email.

(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." Other statements by the court: "already fixed or vested right"; sale was "virtually certain to occur"; "bonus payouts and distributions could not be clawed back"; written final consent was "a foregone conclusion"; no substantial "unresolved contingencies"; "formal shareholder approval was purely ministerial." Because the *Hoensheid* court ruled that the anticipatory assignment of income doctrine applied, the Donors were 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, with which the court did not take issue, and furthermore, 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 Donors' attorney was a competent professional with sufficient expertise to justify reliance, and Donors adhered to her advice that "execution of the definitive purchase agreement" was the firm deadline for avoiding capital gains. While the attorney's substantive tax advice was incorrect, it was reasonable for Donors to rely on it.

Estate of Hoensheid v. Commissioner, T.C. Memo. 2023-34 (March 15, 2023, Judge Nega).

(4) **Basic Facts.** Mr. Hoensheid (Donor) and his two brothers each owned one-third of CSTC (Company) that manufactured heat-treating metal fasteners for use in autos and other commercial vehicles. After one brother announced his intention to retire, the three brothers in

the fall of 2014 decided to explore selling the Company. They concluded with their investment banking firm (Firm) that $80 million was a fair target price. In early 2015 the Firm began soliciting bids, and the ultimate purchaser (Purchaser) submitted a bid for $92 million on April 2, 2015.

Mr. Hoensheid and his wife (collectively referred to as Donors) wanted to give some of his stock to a Fidelity donor advised fund (DAF) and began discussing the donation with Fidelity in mid-April 2015. A longtime tax and estate planning attorney at Donor's law firm advised him that to avoid recognizing capital gains on the donated shares, "the transfer would have to take place before there is a definitive agreement in place." [Observation: The court ultimately determined that is not the correct test.]

Donor emailed his attorney that he and his wife wanted

> to put 3.5MM in the fund, but I would rather wait as long as possible to pull the trigger. If we do it and the sale does not go through, I guess my brothers could own more stock than I and I am not sure if it can be reversed. I have not definitively given [his wealth advisor] a number. Please know this and help us plan accordingly.

The following is a brief chronology of activity 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 draft of the purchase agreement with a recital that "On July …, 2015 [petitioner] transferred 1,380 shares of Common Stock to" the DAF. (The ellipsis and bracketed insert are in the court's opinion.)
- July 10, 2015 – Purchaser prepared a revised draft of the stock purchase agreement that still left blank the date of transfer of shares to the DAF and proposed resolving an outstanding negotiating issue about an environment liability.
- July 10, 2015 – Three significant actions occurred. (1) About $6.1 million of employee bonuses were paid. (2) The Company's Article of Incorporation were amended as requested by Purchaser. (3) The attorney forwarded an updated draft of the minority stock purchase agreement to be signed by Fidelity for the DAF.
- July 13, 2015 – A revised stock purchase agreement was prepared that still left blank the date of the transfer of shares to the DAF. Later that morning, an advisor requested Fidelity to sign the minority stock purchase agreement, but Fidelity responded that it must receive the stock certificate before it could sign that agreement. About 30 minutes later a PDF stock certificate was emailed to Fidelity. It was undated but stated that 1,380.40 shares were owned by the DAF. Later that day, the Company confirmed that 1,380 shares had been transferred to the DAF and Fidelity signed the minority stock purchase agreement agreeing to sell those shares to Purchaser.
- July 14, 2015 – Attorneys for the Company forwarded a revised draft of the stock purchase agreement stating that the contribution to the DAF was made on July 10, 2015. The Company made a dividend distribution of the remaining cash in the Company, about $4.8 million, to the brothers (none to the DAF).
- July 15, 2015 – The Purchaser, Company, and the three brothers signed the final stock purchase agreement (with the provision stating that 1,380 shares had been transferred to the DAF on July 10, 2015), and a representative of Fidelity signed a document assigning 1,380 shares to Purchaser in return for about $2.94 million.
- November 18, 2015 – Fidelity sent Donor and his wife an amended contribution confirmation letter acknowledging a contribution of 1,380.400 shares on June 11, 2015, stating that Fidelity had exclusive control over the shares and that it provided no goods or services in exchange for the contribution.

Donors received a quote from a national accounting firm to appraise the donated shares but decided to use an appraisal that would be prepared for no additional charge by a representative of the Firm. The representative, who had performed limited valuations but no prior appraisals substantiating a charitable contribution of shares of a closely held corporation, prepared an appraisal of the donated shares as of June 11, 2015, providing three different values, one of which was the actual amount received by Fidelity (about $2.94 million) and two others taking into consideration additional payments made to the brothers (but not the DAF). The highest value (about $3.28 million) was reported as the value on Donors' income tax return to support the charitable deduction.

A notice of deficiency disallowed the claimed charitable deduction and applied a penalty under §6662(a). Donor filed a petition with the Tax Court contesting the disallowance of the charitable deduction and penalty. The IRS's amended answer in the Tax Court proceeding for the first time asserted that Donor made an anticipatory assignment of income and should have reported the 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.

(5) **Issues.**

(1) Whether and when Donors contributed 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).

(6) **Whether and When Donor Contributed to the 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, 2015, 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 presumably 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.**

(7) **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 (resulting from 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).

(8) **Charitable Deduction Contribution.**

Section 170(f)(8)(A) and (11)(D) set forth two requirements for receiving a charitable deduction in this situation: (1) a contemporaneous written acknowledgement of the donation by the charitable organization; and (2) a qualified appraisal.

The contemporaneous written acknowledgement requirement was satisfied. The acknowledgement must be received before the relevant tax return was required or, if earlier, the due date of the return. For a gift to a donor advised fund, the written acknowledgement must state that the donee "has exclusive legal control over the assets contributed." §170(f)(18). 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 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.

> **Observation:** Clary Redd (St. Louis) bluntly remarks – "The disallowance of the charitable deduction happened due to rank sloppiness. The rules in the statute and regulations are not that hard to interpret and follow, and they didn't even come close."

(9) **Section 6662(a) Penalty.**

Section 6662(a) imposes a 20% penalty for any underpayment attributable to negligence or a substantial underpayment of income tax (with "substantial" meaning that the understatement exceeds the greater of 10% of the tax required to be reported or $5,000). The notice of deficiency assessed the penalty because of the disallowed charitable deduction, but in an amended answer, the IRS conceded that the penalty related to the charitable deduction would not apply but asserted a new §6662(a) penalty related to the anticipatory assignment of income. Because that assessment came after the notice of deficiency, the IRS bore the burden of proof that no defenses to the penalty applied.

The relevant issue was different from 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.

(10) **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 might also have been applicable in *Keefer*. 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 20.d below20.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) (discussed below). The *Hoensheid* court distinguished Rev. Rul. 78-197 and *Rauenhorst* by saying that the Tax Court has not adopted Rev. Rul. 78-197 and the anticipatory assignment of income test and quoting the statement in *Dickinson v. Commissioner*, T.C. Memo. 2020-128, that "[f]or a taxpayer to rely on a revenue ruling, the facts of the taxpayer's transaction must be 'substantially the same as those considered in the revenue ruling.'" Those statements are followed by this, as the complete analysis of the court's conclusion as to why Rev. Rul 78-197 does not apply:

> On the particular facts of this case, we do not find respondent's arguments to be sufficiently contrary to Rev. Rul. 78-197 to constitute a disavowal of his published guidance. *See* Rev. Rul. 78-197, 1978-1 C.B. at 83 (describing its application as only to "proceeds of a redemption of stock under facts similar to those in *Palmer*"); *cf. Rauenhorst*, 119 T.C. at 182-183 (focusing on Commissioner's argument that courts are not bound by revenue rulings and his reliance on a case that had been distinguished by the Commissioner in a prior private letter ruling).

In effect, the court seems to be saying that Rev. Rul. 78-197 does not apply because it addressed "proceeds of a redemption of stock" (i.e., a purchase of the charity's stock by a corporation), whereas the *Hoensheid* situation involved a purchase of the charity's stock by a third party, not by the issuing corporation.

Observation: That seems to be a stretch to find a distinction. Clary Redd (St. Louis) is more blunt: "That is an unprincipled distinction that should not make a difference. The taxpayer in this case got a raw deal."

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 that the Tax Court had 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 one is legally bound, or can be compelled by the corporation, to surrender the shares for redemption."

Rauenhorst involved a contribution of stock warrants to charities which seven days later agreed to sell them to a purchaser who was going to purchase all the stock of the corporation. The IRS argued that the donor's right to receive the sale proceeds from the stock sale had "ripened to a practical certainty" at the time of the assignments, and the assignment of income doctrine should apply. The court summarized Rev. Rul. 78-197 as establishing a "bright-line" test:

> The Internal Revenue Service (IRS), in Rev. Rul. 78-197, 1978-1 C.B. 83, acquiesced to our decision in *Palmer v. Commissioner, supra,* and in doing so devised a "bright-line" test which focuses on the donee's control over the disposition of the appreciated property. …

119 T.C. at 165.

The court then stated that it had not adopted the bright-line test of Rev. Rul. 78-197.

> [W]e have indicated our reluctance to elevate the question of donee control to a talisman for resolving anticipatory assignment of income issues. For example, in *Allen v. Commissioner,* 66 T.C. 340, 347-348 (1976), we stated that the donee's power to reverse the donor's anticipated course of disposition "is only one factor to be considered in ascertaining the `realities and substance of the transaction.'" Cf. *Jones v. United States,* 531 F.2d 1343, 1346 (6th Cir. 1976). In a more recent opinion, we further extrapolated our position as follows:
>
> > In determining the reality and substance of a transfer, the ability, or the lack thereof, of the transferee to alter a prearranged course of disposition with respect to the transferred property provides cogent evidence of whether there existed a fixed right to income at the time of transfer. Although control over the disposition of the transferred property is significant to the assignment of income analysis, the ultimate question is whether the transferor, considering the reality and substance of all the circumstances, had a fixed right to income in the property at the time of transfer. [*Ferguson v. Commissioner,* 108 T.C. at 259; citations omitted.]
>
> This Court has not adopted the "bright-line" test stated in Rev. Rul. 78-197, *supra,* as the test for resolving anticipatory assignment of income issues, and instead we have considered the donee's control to be merely a factor, albeit an important factor.

119 T.C. at 166.

The IRS argued that the appropriate test was whether the sale was a "practical certainty" before the contribution, which the court viewed as an abandonment by the IRS of its "legally obligated" test from Rev. Rul. 73-197: "When respondent's arguments are boiled down to their essential elements, he argues against the validity of the bright-line test of Rev. Rul. 78-197 …."

The court stated, in very forceful terms, though, that the IRS was bound to follow its own revenue rulings.

> Respondent's counsel may not choose to litigate against the officially published rulings of the Commissioner without first withdrawing or modifying those rulings. The result of contrary action is capricious application of the law. [Quoting *Phillips v. Commissioner,* 88 T.C. at 529, 534 (1987).]

119 T.C. at 172.

Thus, although the *Rauenhorst* court stated that it did not adopt the bright-line test in Rev. Rul. 78-197, because it viewed the IRS's position as contrary to its own revenue ruling, the court proceeded to decide the case based on "whether the charitable donees were legally obligated or could be compelled to sell the stock warrants at the time of the assignments." The Tax Court reasoned that Rev. Rul. 78-197 had been in existence nearly 25 years without being revoked or modified and the taxpayers relied on that ruling in planning their charitable contributions. The IRS pointed to various facts suggesting that the right to the sale proceeds had "ripened to a practical certainty" before the transfer to the charity, but the court viewed that as unimportant:

> Those items might be particularly relevant for determining whether the stock warrant purchase ripened to a practical certainty; however, none of those items alone, or in combination, show that the donees were legally bound, or could be compelled, to sell their stock warrants.

That reasoning would suggest that in Tax Court litigation the court should apply the legally obligated "bright-line" test in any case in which the IRS argues that a "practical certainty" test or any test other than the legally obligated test should govern to determine whether there is an assignment of income if assets contributed to charity are sold soon after by the charity.

Although the "virtually certain to occur" approach in *Hoensheid* is consistent with the Court's statement in *Rauenhorst* that it does not adopt the legally obligated test as the proper approach, the approach in *Hoensheid* seems hard to reconcile with the analytical approach in and result of *Rauenhorst* (again, a full Tax Court opinion).

(d) **A Tax Court Case Basing a Holding on the Burden of Proof.** Tax Court cases very frequently mention which party has the burden of proof as to particular issues, but go on to say that it does not matter in the particular case because the court is making its decision based on a preponderance of the evidence. *Hoensheid* is an example of a case in which one of the holdings (the penalty issue) apparently was based on the IRS not meeting its burden of proof (i.e., "respondent has failed to establish").

c. **Assignment of Income Applied and Charitable Deduction Denied*, Keefer v. United States***

Keefer v. United States held that the assignment of income doctrine applied because a partial interest in assets, rather than the "entire asset," was conveyed to charity before its sale of the asset. The charitable deduction was denied because the acknowledgement from the donor advised fund did not say the DAF had exclusive legal control over the assets contributed (which is one of the required substantiation requirements for charitable gifts to a DAF). *Keefer v. United States*, 130 AFTR 2d 2022-5406 (N.D. Tex. August 10, 2022) (denying motion for reconsideration of Order (130 AFTR 2d 2022-5002 (July 6, 2022)) denying charitable deduction for failure to meet contemporaneous written acknowledgement requirement).

For further discussion of *Keefer*, see Item 27.c of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

d. **No Assignment of Income, *Dickinson v. Commissioner*.**

The court summarized that the assignment of income doctrine applies in the context of this fact situation "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 donated stock. But the second leg was not satisfied. The taxpayer made charitable gifts on three occasions (which Fidelity immediately sold pursuant to its policy), but 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.

Dickinson v. Commissioner, 130 AFTR 2d 2022-5002 (July 6, 2022) 130 AFTR 2d 2022-5405 (N.D. Tex. August 10, 2022) (denying motion for reconsideration))

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.**

23. Successor Trustee of Revocable Trust and Trust Beneficiaries, Who Were Appointed and Received Distributions After Decedent's Death, Were Personally Liable for Unpaid Estate Taxes, *United States v. Paulson*, 131 AFTR 2d 2023-1743 (9th Cir. May 17, 2023), *cert. denied* (U.S. March 4, 2024) (No. 23-436)

a. **Synopsis.** The decedent died in 2000 with most of his assets in a revocable living trust. The executors filed the estate tax return; they paid some estate tax and deferred the rest under §6166. The IRS and the estate in 2005 agreed to a much higher estate tax, which was deferred under §6166. Most of the estate tax was never paid. Distributions were made to various trust beneficiaries between 2003 and 2006. Various family members were appointed as successor trustees in 2009 and 2011.

In 2015, the IRS filed an action against the estate and living trust for the balance of the estate tax liability (then over $10 million). The IRS also sought judgment under §6324(a)(2) against various family members in their capacities as successor trustees and as beneficiaries.

The district court made various determinations, including that certain individuals were not liable as transferees or trustees because they were not in possession of estate property at the time of the decedent's death.

The Ninth Circuit Court of Appeals reversed that decision. This is the **first case** holding that personal liability under §6324(a)(2) is extended to successor trustees and trust beneficiaries who are appointed or receive property *after* the decedent's death (in this case, years later). (Over the last 70 years, prior cases held that §6324(a)(2) and its predecessors applied only to specified classes of individuals who hold or receive (or have the right to immediate receipt of) property in the gross estate at the time of the decedent's death.) In addition, the court held that "beneficiaries" who are personally liable under 6324(a)(2) include trust beneficiaries, not just life insurance or annuity beneficiaries.

A dissenting opinion viewed the majority's analysis as a "hypertechnical reading" of statutory language (applying the "rule of the last antecedent" because of the lack of a comma after a particular word) that results in an interpretation with illogical results. The illogical result is that individuals may become successor trustees or receive distributions at a time after values have declined so much that their personal liability for estate tax exceeds the value of the property when received. The IRS made "avowals" in briefs and oral argument that it would not pursue that "excess" liability, but those "avowals" are not binding in future cases.

The conclusion of the majority opinion is that successor trustees who are appointed after the decedent's death and trust beneficiaries who receive trust distributions after the decedent's death are personally liable for estate taxes under §6324(a)(2), but the personal liability of successor trustees is capped at "the value of the property at the time that they received or had it as trustees," and the personal liability of trust beneficiaries "cannot exceed the value of the estate property at the time of decedent's death, or the value of that property at the time they received it."

United States v. Paulson, 131 AFTR 2d 2023-1743 (9th Cir. May 17, 2023), *cert. denied* (U.S. March 4, 2024) (No. 23-436).

b. **Facts.** Allen Paulson ("Allen"), who was an executive of Gulfstream Aerospace Corp., died July 19, 2000. Nearly all his assets were held in a revocable living trust. When Allen died, his son John Michael Paulson became co-trustee and was appointed co-executor.

In October 2001, John became sole executor and co-trustee with a different co-trustee. That month, John filed an estate tax return reporting a total gross estate of $187.7 million, a net taxable estate of $9.2 million, and an estate tax liability of $4.5 million. The estate paid about $700,000 and deferred the balance under §6166.

The IRS audited the estate tax return. Eventually the Tax Court (in December 2005) entered a stipulated decision determining that the estate owed an additional $6.7 million of estate tax, which the estate elected to defer under §6166. The executor made one estate tax and interest payment in 2007 and made some other interest payments. No one paid any subsequent installment payments.

The executor made distributions to Allen's widow in 2003 (worth between $19 million and $42 million) and to other beneficiaries (including Allen's granddaughter, Crystal Christensen) of at least $7.3 million between 2003 and 2006.

Various disputes arose among the beneficiaries. In 2009 the probate court removed John Michael Paulson as co-trustee of the living trust for misconduct and appointed Vikki Paulson (the widow of Allen's son who died after Allen's death) and James Paulson (one of Allen's sons) as successor co-trustees. The IRS asserted that the living trust contained assets at that time worth more than $13.7 million (which exceeded the estate tax liability). Vikki and Crystal claimed the trust was insolvent at that time but agreed that the trust assets exceeded the tax liability. In 2011, the probate court appointed Crystal as co-trustee with Vikki. The IRS asserted that the living trust assets were worth at least $8.8 million at that time. In January 2013, the family members resolved disputes among themselves and entered into a settlement agreement, pursuant to which John Michael Paulson received various assets in exchange for resigning as executor. Vikki and Crystal asserted that the living trust by that time was "completely depleted."

In 2015, the IRS filed an action against the estate and living trust for the balance of the estate tax liability (then over $10 million). The IRS also sought judgment under §6324(a)(2) against all the individuals named above in their individual and representative capacities.

The district court entered various findings, including that Vikki Paulson and Crystal Christensen were not liable as transferees or trustees because they were not in possession of estate property at the time of Allen's death. *United States v. Paulson*, 204 F. Supp. 3d 1102, 118 AFTR 2d 2016-5665 (S.D. Calif. 2016). The district court's determination was appealed to the Ninth Circuit Court of Appeals.

c. **Holding.** The Ninth Circuit Court of Appeals reversed that determination and remanded to the district court to determine the amount of each defendant's liability for unpaid taxes.

(3) **Interpretation of §6324(a)(2)**. Section 6324(a)(2) imposes personal liability for unpaid estate taxes on categories of persons listed in the statute (including a surviving joint tenant, transferee, trustee, or beneficiary) who (1) *receive* estate property *on or after* the date of the decedent's death, or (2) have estate property on the date of the decedent's death.

(4) **Application of Interpretation of §6324(a)(2) to Facts.** James Paulson and Vikki Paulson (who became successor co-trustees nine years after Allen's death) and Crystal Christensen (who became successor co-trustee eleven years after Allen's death) are liable, **as trustees**, for unpaid

estate taxes on property from the gross estate held in the living trust, capped at the value of estate property in the living trust at the time of Allen's death, but each defendant's "liability cannot exceed the value of the property at the time that they received or had it as trustees." 131 AFTR 2d 2023-1743, at 1758.

In addition, Crystal Christensen and Madeleine Pickens are liable as **trust beneficiaries** under §6324(a)(2) for unpaid estate taxes, but their liability "cannot exceed the value of the estate property at the time of [Allen's] death or the value of that property at the time they received it." 131 AFTR 2d 2023-1743, at 1762. (Crystal received some property as a trust beneficiary between 2003 and 2006, years before she became successor co-trustee, and her liability as to that property, capped at the value of such property on the date of her receipt, would be different than her liability as trustee capped at the value of the living trust assets when she became successor co-trustee some years later.)

d. **Majority Opinion Analysis.**

(3) **Overview.** The court's analysis focused on two issues regarding what persons are subject to personal liability under §6324(a)(2) in the factual context of certain individuals (who were either successor co-trustees or beneficiaries, or both).

First, does §6324(a)(2) apply to specified persons who receive property after the date of the decedent's death in addition to persons who have property at the time of the decedent's death? The 2-judge majority concluded that it does, contrary to the prior accepted interpretation of the statutory language. A dissent by the remaining judge argues strongly that it does not, which would have meant the individuals were not personally liable for the unpaid estate tax.

Second, does the reference to "beneficiaries" in §6324(a)(2) include trust beneficiaries? (The court concluded that it does, contrary to prior cases that would limit the term to beneficiaries of life insurance or annuities.)

In addition, the court limited the personal liability to the lesser of (1) the value of assets on the date of death that were later received as beneficiaries or accepted as trustees or (2) the value of such assets when received or accepted, even though the statute merely provides the first limitation.

(4) **Section 6324(a)(2).** The IRS asserted personal liability of successor trustees and trust beneficiaries under §6324(a)(2). (As discussed below, another possible statutory remedy for personal liability is "transferee liability" under §6901, but the IRS did not assert personal liability under §6901.)

Section 6324(a)(2) provides as follows:

> If the estate tax imposed by chapter 11 is not paid when due, then the spouse, transferee, trustee [with one exception not relevant], surviving tenant, person in possession of the property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax. …

The relevant parts of §6324(a)(2) (split apart into the relevant clauses that are numbered for convenience in referring to the clauses) for the *Paulson* facts are:

[1] "If the estate tax … is not paid, then

[2] the … trustee, … or beneficiary,

[3] who receives, or has *on the date of the decedent's death*, property included in the gross estate under sections 2034 to 2042, inclusive,

[4] to the extent of the value, at the time of the decedent's death, of such property,

[5] shall be personally liable for such tax…"

Comment: Prior to *Paulson*, this provision has been interpreted as follows:

the only persons who have primary personal liability for the estate tax should be (1) the executor (and not the probate estate heirs), and (2) the non-probate estate fiduciaries and beneficiaries (using that term broadly) who hold or receive (or have the right to immediate receipt of) the property as of the death date, up to the value of the property on that date.

Jasper L. Cummings, *Scalia's Rules and Tax Collection*, 181 TAX NOTES FEDERAL 2179, at section I.B (Dec. 18, 2023) (hereafter "Cummings Article"). The Cummings Article derives its title from Antonin Scalia & Bryan A. Garner, READING LAW: THE INTERPRETATION OF LEGAL TEXTS (2012), a book about statutory interpretation co-authored by the late Supreme Court Justice Antonin Scalia that was cited several times in the *Paulson* majority opinion.

(5) **"On the Date of the Decedent's Death" Issue**. The court applies a detailed statutory construction analysis to determine whether the phrase "*on the date of the decedent's death*" refers to both "receives" and "has" or refers only to "has." The government argued that it refers only to "has" so the statute imposes personal liability on the specified persons who "(1) receive estate property at any time on or after the date of the decedent's death, or (2) have estate property on the date of the decedent's death." Therefore, the statute imposes personal liability on "successor trustees or beneficiaries of the living trust, including those who have or received estate property after the date of" Allen's death. The court agreed with the government's interpretation, with a very detailed analysis of construction principles.

Observation: The court got bogged down with its detailed technical rules-of-construction analysis. A "natural reading" of the sentence, with its "or has on the date of the decedent's death " clause set off by commas, is that the "on the date of the decedent's death" limitation applies only to property a person "has" on the date of death and not property that the person "receives." A possible interpretation of the intent of the statute is that it begins with the notion of a person "who receives property included in the gross estate under section 2034 to 2042 inclusive." But it is possible that a person would not have to "receive" the property because the person might already "have" it – especially for property described in §2034 to §2042, which focus on transfers made before death that "ripen" into possession or at least some type of vested interest at death. To close that gap, the statute adds "or has on the date of the decedent's death," appropriately set off by commas at both the beginning and the end.

The problem with that common sense interpretation of the statute, as pointed out by the taxpayers (discussed immediately below), is that the personal liability could exceed the value "received" at the time of receipt, which creates an ambiguity that should be resolved by focusing on the legislative intent. As discussed below, the majority "fixes" that problem by limiting the personal liability to the value at the time of the receipt, even though the statute does not say that.

The taxpayers argued that interpreting the statute to refer to any persons who receive gross estate property at any time after the decedent's death leads to absurd results because that (1) could make purchasers of property liable for unpaid estate tax and (2) could result in personal liability for estate tax that exceeds the value of property when it is later received.

As to the first example, the majority responded that §6324(a)(2) by its terms does not apply to purchasers (they are not one of the six categories of listed persons, and the last sentence of §6324(a) specifically addresses the effect of a transfer to a purchaser).

The court's discussion of the second example results in a very important caveat in the court's final description of its interpretation of the statute. This example relates to clause [4] of §6324(a)(2) as described above, limiting liability to "the value, at the time of the decedent's death, of such property." The court discusses a number of events that would have to occur before a person who later receives gross estate property would have liability that exceeds the value the property at the time it is first received by the person. The most important of the contingencies that would have to occur is that the IRS "would seek to impose tax liability on a transferee, beneficiary, or other recipient of estate property in an amount that exceeds the value of the property they received." The court relied on the "government's avowals in its briefing and

at oral argument that estate tax liability cannot exceed the value of the property received" and that "a person's liability is capped at the value of the property had or received." 131 AFTR 2d 2023-1743, at 1755. The majority believed that the government would be judicially estopped from asserting such excess liability on any of the parties in this case and that no cases have been identified in which the government attempted to impose personal liability for estate taxes that exceeded the value of the property received.

The court acknowledged that two prior cases rejected the government's interpretation of the statute limiting liability to the value of property when received or accepted. *Englert v. Commissioner*, 32 T.C. 1008 (1959) (interpreting a predecessor statute to §6324(a)(2)); *United States v. Johnson*, No. CV 11-00087, 2013 U.S. Dist. LEXIS 106671, 2013 WL 3924087 (D. Utah 2013). The court rejected the reasoning of both cases as superficial. No prior case has accepted the government's position, so this is the first and only case to adopt the court's interpretation of §6324(a)(2).

(6) **Interpretation of "Beneficiary" to Include Trust Beneficiaries.** The taxpayers argued that the reference to "beneficiaries" in §6324(a)(2) does not include trust beneficiaries but the term as used in §6324(a)(2) refers to life insurance beneficiaries. (Presumably they would also acknowledge that it includes beneficiaries of annuities included in a decedent's gross estate under §2039.)

As another "first," the court for the first time reaches the conclusion that trust beneficiaries who receive property after a decedent's death have personal liability under §6324(a)(2). The court refers to two construction principles in the discussion of the meaning of "beneficiary": (1) "the word's ordinary meaning;" and (2) "presumption of consistent usage."

The taxpayers pointed to two cases in 1934 and 1959 interpreting predecessor versions of the statute that interpreted "beneficiaries" to include just life insurance beneficiaries (*Higley v. Commissioner*, 69 F.2d 160 (8th Cir. 1934); *Englert v. Commissioner*, 32 T.C. 1008 (1959)), and two more recent cases (1994 and 2013 cases) applying the reasoning of those cases to interpret §6324(a)(2). The majority opinion distinguished the cases interpreting predecessor statutes based on differences in the predecessor statutes. 131 AFTR 2d 2023-1743, at 1759-1760. The court rejected the conclusion of the 1994 case, *Garrett v. Commissioner*, T.C. Memo. 1994-70, because of its superficial acceptance of the reasoning of the prior cases despite the differences in the predecessor statutes. (One commentator critical of *Paulson* counters that "the law did change but not in a material way." Cummings Article at section III.B.2.) The court did not address the analysis of this issue in the more recent district court case that also reached a contrary result, *United States v. Johnson*, 2013 U.S. Dist. LEXIS 106671, 2013 WL 3924087 (D. Utah 2013).

(7) **Conclusion of Interpretation of §6324(a)(2) and Finding that Successor Co-Trustees and Trust Beneficiaries Who Became Co-Trustees and Received Assets After the Date of Death Are Personally Liable, But with a Cap on the Personal Liability.** The court concluded that the successor co-trustee had personal liability for the unpaid estate taxes and two of the trust beneficiaries who received trust assets years after the decedent's death also had personal liability for the unpaid estate tax, but with a cap on the degree of their personal liability.

> We conclude that the ordinary meaning of beneficiary, which includes trust beneficiaries, applies to § 6324(a)(2), and we are not persuaded that the structure or context of the statute, or policy considerations, require a narrower interpretation as the defendants argue. Moreover, applying the presumption of consistent usage further supports our conclusion that the term beneficiary in the tax code includes trust beneficiaries. Therefore, we conclude that Crystal Christensen and Madeleine Pickens are liable for the unpaid estate taxes under § 6324(a)(2) as beneficiaries. However, the liability of each of these defendants cannot exceed the value of the estate property at the time of decedent's death, or the value of that property at the time they received it.

131 AFTR 2d 2023-1743, at 1761-1762.

The cap on each person's personal liability is not to "exceed the value of the estate property at the time of decedent's death, or the value of that property at the time they received it."

The Ninth Circuit remanded the case to the district court for further proceedings "necessary to determine the amount of each defendant's liability of the unpaid taxes."

e. **Dissent Analysis.** The following is a discussion of the dissent by Judge Ikuta. It is an extensive discussion because the dissent provides a persuasive rebuttal to the majority opinion and is consistent with the interpretation that has been applied to the statute and its predecessors for 70 years.

The dissent begins with the importance of determining the Congressional intent of §6324(a)(2), and if a statute is ambiguous, the court must consider "the most logical meaning" of the statute (quoting a prior Ninth Circuit case).

The dissent's primary argument is that interpreting the statute to impose personal liability for estate taxes on persons receiving estate property after the decedent's death results in an illogical taxing system because the value of the property received years later may be less than the estate tax imposed based on the date of death value of that property.

(3) **Prior Case Law.** Prior cases interpreting §6324(a)(2) and its predecessors have concluded that the statute applies only to persons who have or receive property *on the date of the decedent's death* that is included in the gross estate (citing *Englert v. Commissioner* (1959), *Garrett v. Commissioner* (1994), and *United States v. Johnson* (D. Utah 2013)). Section 6324(a)(2) was amended in 1966 (after *Englert* and *Garrett* were decided), and the failure to change the syntax of the relevant clause "indicates that Congress intended to keep the then-current judicial interpretation" (citing *Lorillard v. Pons*, 434 U.S. 575, 580 (1978) ("Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change")).

The dissent emphasizes that the interpretation adopted by the majority is the **"first time"** a court has reached that result.

(4) **Criticism of Majority's Reliance on Technical Grammatical Rules to Reach Illogical Result.** The dissent decries the majority's interpretation that reaches an illogical result based on "the lack of a comma" and an interpretive presumption based on the grammatical rule against misplaced modifiers.

(5) **Criticism of Majority's Response to "Illogical Results" Argument Because They Are Unlikely to Occur.** The majority responds to the "illogical results" argument by saying they are unlikely to occur for various reasons. One reason is that the beneficiary could disclaim and therefore avoid having a personal liability that exceeds the value of property when it is received from the estate. But the dissent points out that disclaimers generally must occur within nine months of the decedent's death, and at that point a beneficiary would have no way to know that the property would decline in value so precipitously before distribution that the beneficiary's personal liability for estate taxes would exceed the value received.

The dissent is particularly bothered with the majority's reliance on the government's "avowals" that it would not assert personal liability against a beneficiary for more than the value received by the beneficiary at the time of distribution. First, it noted the government's "avowals in its briefing and at oral argument … is merely a description of how the government has argued this case. It does not represent the government's interpretation of §6324(a)(2) or any promise regarding its future actions." Judicial estoppel is not applicable for various reasons. Furthermore, even if the government had purported to apply an interpretation that liability could not exceed the amount received, "such interpretation would still not be binding in future cases," and the government could change its position. Even if the government has not historically imposed personal liability that exceeded the value of property received, that "indicates only that the government has managed up until now to use special liens or surety bonds to secure its interest, but does not establish that the government's interpretation of § 6324(a)(2) is reasonable."

f. **More Detailed Discussion.** For a more detailed discussion of the analysis by the majority and dissenting opinions, see Item 26.d-e of Estate Planning Current Developments and Hot Topics

(December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

g. **Request for Rehearing Denied.** Taxpayers filed petitions for a rehearing en banc by the entire Ninth Circuit panel of judges, but that petition was denied July 25, 2023.

h. **Petition for Certiorari.** A petition for certiorari was filed with the U.S. Supreme Court (No. 23-436) on October 23, 2023, and the government filed its brief in opposition on January 29, 2024. Arguments in the petition include the following.

(3) **Intolerable Conflict With Prior Cases.** The opinion creates an intolerable conflict regarding the scope of personal liability under §6324(a)(2) with the Tax Court and every federal court that has considered the issue (citing *Englert v. Commissioner*, 32 T.C. 1008, 1015 (1959), *acq*. 1960 WL 62561 (Dec. 31, 1960); *Garrett v. Commissioner*. Memo. 1994-70; and *United States v. Johnson*, 2013 U.S. Dist. LEXIS 106671, 2013 WL 3924087, 112 AFTR 2d 2013-5474 (D. Utah 2013)).

(4) **Misapplies Rules of Construction.** The opinion misapplies the last antecedent rule of statutory construction and the rule of taxpayer lenity.

(5) **Conflicts With Sound Public Policy.**

(a) **Attempts to Amend §6324(a)(2) by Judicial Fiat.** The opinion attempts to resolve the practical problem of the possible overly broad potential personal liability resulting from its interpretation of the persons to whom the statute applies by limiting personal liability to the value of property after the date of death at the time of becoming a trustee or receiving property as a beneficiary, contrary to the explicit terms of the statute.

> Recognizing that its novel interpretation of the scope of § 6324(a)(2) could impose substantial and unanticipated personal liability on recipients of estate property, the Ninth Circuit sought to limit those consequences by announcing that personal liability will be "capped at the value of estate property in the living trust at the time of Allen Paulson's death, and each defendants' liability cannot exceed the value of the property at the time that they received or had it as trustees." Pet. App. 49a. The Ninth Circuit decision created this new cap on personal liability for estate taxes out of whole cloth. It cites no authority—no statutory language, no tax regulation, no case law, no treatise—to support this extraordinary exercise in judicial law-making. This overreaching is contrary to this Court's precedent. *See, e.g., Griffin v. Oceanic Contractors*, 458 U.S. 564, 576 (1982); *Crooks v. Harrelson*, 282 U.S. 55, 60 (1930). If Congress believed that the Tax Court and other federal courts' interpretation of § 6324(a)(2) is incorrect or produces unacceptable results, it could amend the statute at any time, as it has on several occasions in the past.

(b) **Conflicts With Application of Judicial Estoppel.** The opinion conflicts with binding precedent as to the application of the doctrine of judicial estoppel against the government.

> The premise for the Ninth Circuit's creation of a new cap on personal liability for estate taxes under § 6324(a) (2) is its belief that the Government allegedly promised in its briefing and at oral argument that "estate tax liability cannot exceed the value of property received," and that it will not pursue recipients in this case for "more than the value of the property that the taxpayer received." Pet. App. 38a. According to the Ninth Circuit, application of the "doctrine of judicial estoppel" will safeguard against any unfair application while imposing personal liability. *Id*. at 38a-42a. It will also bind the Government to that limitation on recovery of unpaid estate taxes in future cases.
>
> …
>
> Nevertheless, the Ninth Circuit's decision stands as support for the erroneous proposition that the United States Government can be bound to its purported concession in its brief in future actions. This proposition raises serious constitutional concerns based on separation of powers. …
>
> Moreover, if the Ninth Circuit decision stands, the Government would be invited to engage in creative brief writing and attempt to use this new "doctrine strategically to achieve results Congress intended to prevent, thus delivering lawmaking power to the executive." *Marine Shale Processors*, 81 F.3d at 1348. These conflicts with sound public policy need to be resolved to ensure uniform national enforcement of the tax laws.

The National Taxpayers Union Foundation filed an amicus brief on December 19, 2023, arguing that the statute is ambiguous and should be construed in favor of taxpayers. The government filed its

brief on January 29, 2024, largely reiterating the reasoning in the court of appeals opinion (including a detailed analysis distinguishing *Englert v. Commissioner*, a prior case interpreting the predecessor to §6324(a)(2) to apply it only to property received or held on the date of death) and also arguing that the case is a poor vehicle for resolving the underlying issues because it is an interlocutory appeal rather than an appeal from a final ruling.

The Supreme Court denied the petition for writ of certiorari on March 4, 2024.

i. **Criticism of *Paulson*.** The *Paulson* opinion has been roundly criticized by some commentators. Some of the arguments in the Cummings Article are summarized below.

(3) **Overview.**

> This article will focus on a circuit court decision for the IRS in a collections case, *Paulson*, involving a legal issue of statutory interpretation that should have been resolved long ago, and in fact was. Somehow *Paulson* was decided the other way, the wrong way, against the taxpayer.
>
> On first reading the circuit opinion, you might agree with it, if you know nothing about the history of the rules and don't think about their purpose. But on further analysis, you can see how the taxpayer probably is right; the district court judge and a dissenter thought so.

Cummings Article at section I.A.

(4) ***Paulson's* Statutory Construction.** The *Paulson* court looked to the "natural reading" of the statute based on punctuation.

> Although the circuit opinion is long, it was over after the judges fixed on the comma separating "receives" from "has." That meant that "on the date of the decedent's death" modified only "has" and not "receives."
>
> Undoubtedly commas can matter. But they should not be controlling, and the Supreme Court has never said they always are.

Id. at section V.A.

(5) **Analysis Should Look Beyond Formalistic Construction to Legislative Intent.**

> The 2-1 circuit opinion reversed the trial court primarily by citing that book on statutory interpretation and hewing closely to formalistic rules rather than search for congressional intent…. At bottom the circuit decision was made when the majority saw that "receives" was on the other side of the comma from "or has on the date of the decedent's death" in section 6324(a)(2) (dating to 1942 and never before interpreted that way by published IRS guidance or a court opinion).
>
> …
>
> The [government's] brief returned repeatedly to the argument that the old cases failed the Supreme Court's contemporary statutory interpretation process, under which courts begin with the statutory text and only look beyond the text when it is ambiguous….It never considered what Congress was trying to do with the section or the problem of a beneficiary being held to a death date liability when it had no right to the death date value.
>
> … **Why would a court reason that way?**
>
> This is the "you broke it, you fix it" approach to statutory interpretation by judges. It gives the appearance of the court acting like Pontius Pilate and washing its hands of the problem. But it is actually washing its hands of the historic judicial task of figuring out what the legislature intended but maybe imperfectly said. Because a court can choose to disregard an interpretive canon or claim it is overcome in rare cases, this approach to statutory interpretation actually invests in full judicial power to go with or against legislative intent, as it suits the judge, while appearing to be impartial.

Id. at section IV.B.1-2.

(6) **Legislative Intent – Personal Liability Regime for Estate Tax.** Section 6901 imposes no personal liability for estate taxes; if the transferee is personally liable under state law (under fraudulent transfer principles), §6901 provides a process for the IRS to collect tax. No provision in the Code imposes personal liability on beneficiaries of assets from the probate estate; instead, the executor is personally liable for estate tax, including tax on non-probate property that does not pass through the executor's hands. §2002 (requires executor to file the estate tax return, who can thus be assessed the tax as the named taxpayer); *see* Cummings Article at section III.A.

Section 6324 imposes personal liability on a beneficiary or fiduciary "who receives, or has on the date of the decedent's death, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property …." Is this interpreted to include beneficiaries or fiduciaries who *receive* non-probate property *after the date of death*? That would impose personal liability for estate taxes on beneficiaries of non-probate property, whereas beneficiaries of probate assets (includable in the gross estate under §2033) have no personal liability for estate taxes. That would make no sense.

> That seems pretty straightforward, and the intent of Congress is obvious: to hold directly responsible for the death date value of gross estate property the people who held or got it on the death date (including persons having a right to immediate possession of the property on that date). Obviously a very common case is property passing outside the probate estate in various ways, including most commonly under an *inter vivos* trust to the trust beneficiaries who did not receive a distribution until after the date of death. Why would Congress except them from this regime of personal liability?
>
> Well, there is one obvious reason: Congress also excepted the beneficiaries of the gross estate. [Section 6324(a)(2)] does not apply to probate estate heirs. And no other section makes them personally liable. None of the opinions discussed that fact.

Cummings Article at section III.A (citations omitted).

This regime still leaves the Treasury protected. The executor is personally liable for estate taxes on probate and non-probate property, and the trustee at the date of death of an inter vivos trust is personally liable for the estate tax on the trust assets. *See id*.

(7) **Prior Cases Regarding "Receives … On the Date of the Decedent's Death" Construction.** Four prior cases have held (or suggested based on related holdings for predecessor statutes) that §6324(a)(2) should not apply to beneficiaries or fiduciaries who receive non-probate assets after the date of death.

United States v. Johnson was cited by the *Paulson* trial court. *United States v. Johnson*, 112 AFTR 2d 2013-5474 (D. Utah July 29, 2013) ("in order for a person to be a transferee under section 6324(a)(2), the person must have or receive property from the gross estate immediately upon the date of decedent's death rather than at some point thereafter"), *subsequent determination that §6324(a)(2) does not apply to funded revocable trusts*, 224 F. Supp. 3d 1220, 118 AFTR 2d 2016-6781 (D. Utah Dec. 1, 2016), *subsequent award of attorney fees because government's position had not been reasonable*, 121 AFTR 2d 2018-341 (D. Utah Jan. 8, 2018), *rev'd as to statute of limitations and attorney's fees*, 920 F.3d 639 (10th Cir. 2019, cert denied, 140 S. Ct. (2019). It held that to be a "transferee" having personal liability for estate tax under §6324(a)(2) the person "must have or receive property from the gross estate immediately upon the date of decedent's death rather than at some point thereafter." 112 AFTR 2d 2013-5474, at 5478. That case reasoned in part that statutory ambiguities should be resolved in favor of the taxpayer, but the Cummings Article observes that "there is no pro-taxpayer presumption for ambiguous sections." Cummings Article at section III.B.1.

Johnson relied primarily on a 1959 Tax Court opinion, *Englert v. Commissioner*, which was also cited in *Paulson*. *Englert v. Commissioner*, 32 T.C. 1008 (1959), *acq*,1960-2 C.B. 4, 9 (estate tax decision). *Englert* involved a predecessor statute to §6324(a)(2) under the 1939 Code, as amended in 1942. *Englert* concluded that "because the trust beneficiary did not receive or hold the trust property on the date of death, the beneficiary was not liable — only the *inter vivos* trustee was liable because the trustee held the property at death." Cummings Article at section III.B.1.

Equitable Life Assurance Society v. Commissioner, 19 T.C. 264 (1952), was cited in the *Englert* opinion. *Equitable Life* held that a life insurance company that held life insurance proceeds on the date of death was not a transferee for purposes of the predecessor to §6324(a)(2).

Higley v. Commissioner, 69 F.2d 160, 13 AFTR 663 (8th Cir. 1934), was not cited by *Paulson* in its discussion of the "receives … on the date of the decedent's death" issue, but it was cited in its discussion of whether "beneficiary" in §6324(a)(2) refers only to life insurance beneficiary (or

annuity beneficiaries). *Higley* concluded that it is "so clear" the term "beneficiary" in a predecessor statute does not include trust beneficiaries. The Cummings Article views *Higley* as the "best cite" because it "more solidly analyzed the purpose and intent of the overall collection scheme." Cummings Article at section III.B.2.

> Passing from consideration of this section alone to *consideration of it as a part of the general scheme of collecting this estate tax*, the position of petitioner is further strengthened. Throughout this chapter (Estate Taxes) runs the clear plan as to collection. The prime reliance is the property subject to the tax. Upon this a lien for the taxes is placed. As further assurance, a *personal liability is placed upon those who are in position to dispose of the property and possibly delay or defeat collection*. Upon them is placed a strong personal incentive to see that the tax is properly and promptly paid. This burden is placed only upon those (executors, administrators, fiduciaries, transferees, trustees, and insurance beneficiaries) who have such legal title, control, and possession as would afford opportunity to dispose of the property primarily liable for the payment of the tax. *A trust beneficiary may or may not occupy such a position, dependent upon the terms of the trust, but all opportunity for him to take advantage thereof is anticipated and guarded against by placing upon the trustee a personal liability and by attaching the lien to the* trust property. Although Congress has legislated repeatedly in this matter, it has in no instance used language clearly providing personal liability of a cestui que trust.

12 AFTR 663, at 666 (emphasis added in Cummings Article).

Higley was subsequently characterized by the Supreme Court as holding that "the personal liability of transferees did not extend to the beneficiaries under a trust." *Allen v. Trust Co.*, 326 U.S. 630, at n.5 (1946).

The Cummings Article points out several times that the IRS has never filed a non-acquiescence in any of these cases. Furthermore, the IRS was aware of the two older cases when it wrote regulations in 1954 regarding §6324(a)(2) and it could have taken a position in regulations clearly opposing the position taken by these cases; it did not do so. Cummings Article at section III.C.2.

(8) **Supreme Court Statutory Construction Cases Involving Commas.** The Cummings Article cites a large number of U.S. Supreme Court statutory construction cases involving commas.

> Throughout its history the Supreme Court has been willing to disregard commas and other punctuation and to insert commas, to reach the intent of Congress. In fact, far more Supreme Court opinions have disregarded commas like the one at issue in *Paulson* than have given commas such a prominent role. And sometimes the Supreme Court has added a comma that did not exist in the statute.

Id., at section V.B.1.

j. **Observations.**

(3) **FIRST CASE to Apply Personal Liability to Trustees or Trust Beneficiaries Who Are Appointed or Receive Distributions Only After Decedent's Death.** This case is notable because it is the first case (and at the federal court of appeals level, no less) to hold that §6324(a)(2) imposes personal liability on persons who are appointed co-trustees after the date of death or on trust beneficiaries who receive property after the decedent's death.

Prior cases (going back over 60 years) applied personal liability for estate taxes under §6324(a)(2) or its predecessors only to persons who were or became trustee at the date of the decedent's death or beneficiaries who have or receive property at the date of death. The first such case was *Englert v. Commissioner*, 37 T.C. 1008 (1959) (construing the predecessor of §6324(a)(2)). The most recent case reaching that same position is the unpublished district court opinion, *United States v. Johnson*, 2013 WL 3924087 (D. Utah July 29, 2013):

> Because section 6324(a)(2) may be interpreted in multiple ways, it is ambiguous and must be interpreted in favor of the Heirs. The court concludes that in order for a person to be a transferee under section 6324(a)(2), the person must have or receive property from the gross estate immediately upon the date of decedent's death rather than at some point thereafter.

(4) **Successor Trustees Should be Wary Before Accepting Office If Estate Tax Remains Unpaid.** Successor trustees of a decedent's revocable trust (or other trust that is included in the decedent's gross estate), who may be appointed years after the decedent's death, must be wary about whether the value of assets remaining in the trust when the trustee accepts appointment

is less than the unpaid estate tax liability of the estate. By accepting appointment, the successor trustee may become personally liable for those estate taxes (in the Ninth Circuit or in other circuits that may adopt the position taken in *Paulson*).

The majority opinion in *Paulson* responded to this potential concern of successor trustees by observing that "trustees serve only if they are 'willing.'" *Paulson*, 131 AFTR 2d 2023-1743 at n.38.

(5) **Trust Distributions May Impact Beneficiaries' Status with Creditors.** If trust distributions from revocable trusts are made before all estate taxes have been paid, Steve Gorin (St. Louis) points out that the beneficiaries have a contingent liability that perhaps should be reflected on balance sheets and to creditors. That contingent liability exists until estate taxes are paid or until the statute of limitations on collections under §6502 have run. Beneficiaries may wish to avoid that complexity with creditors and banks by requesting that trust distributions be delayed until all estate taxes are paid.

(6) **Time Period of Potential Personal Liability.** Persons who have personal liability for estate taxes under §6324(a)(2) may have that liability hanging for a long period of time. Section 6324(a)(2) has no time limits specified, so the general collection provisions of §6501 and §6502 control. Section 6502 requires that an action to collect tax must be commenced within 10 years after the assessment of the tax, which must occur within three years after the estate tax return is filed, §6501(a), or within six years if items are omitted from the gross estate exceeding 25% of the gross estate stated on the return, §6501(e)(2). However, the 10-year period after assessment can be suspended (for example, during a court proceeding, §6503(a)(1)), or extended (for example, during the period of an extension of payment under §6161 or during a deferral period under §6166, §6503(d)). (Similarly, the three-year period for assessment of estate tax is suspended during any Tax Court proceeding or any extension period for the payment of tax under §6161(a)(2), §6161(b)(2), §6163, or §6166. §6503(a)(1); §6503(d).) Accordingly, the collection action could be brought about 13 years after the decedent's death in a normal case and within about 25 years after the decedent's death if estate taxes are extended under §6166.

(7) **Potential Personal Liability Exceeding the Value of Property Received.** The dissent was quite concerned with interpreting the statute in a way that leads to the illogical result of a trustee or trust beneficiary who may have personal liability for estate taxes that exceeds the value of property when received by the trustee or beneficiary because the trustee or beneficiary is personally liable for estate tax up to the value on the date of death (or alternate valuation date) of property received by the trustee or beneficiary. The court recognized that there is no statute (under its interpretation of §6324(a)(2)) or cases that would prevent that possible result. The government made "avowals" in its brief and oral argument that personal liability is limited to the value received, but as the dissent points out, the government did not make promises that it would never take that position in future cases.

Despite the lack of authority for that limitation on personal liability, the Ninth Circuit's conclusion imposes a cap on each person's personal liability of "the value of the estate property at the time of decedent's death, or the value of that property at the time they received it."

The majority opinion reasoned that its construction of §6324(a)(2) to apply to persons who are appointed as trustees or receive trust property after the decedent's death is not illogical despite the possibility that the estate tax could exceed the value of property when received in part because the IRS "avowed" it would not take that position. However, the IRS has taken positions contrary to even published (and not withdrawn) Revenue Rulings in later cases. *See*, *e.g.*, *Estate of Hoensheid v. Commissioner,* T.C. Memo. 2023-34 (despite the court's attempt to distinguish Rev. Rul. 78-197 and *Rauenhorst v. Commissioner*, 119 T.C. 157 (1993)). The IRS in this same case (i.e., *Paulson*) took a position seemingly contrary to Rev. Rul.75-553, and the district court accepted the IRS's position. Similarly, the IRS took a position contrary to Rev. Rul. 75-553 in *United States v. Johnson*, 224 F. Supp. 3d 1220, 118 AFTR 2d 2016-6781 (D. Utah 2016), as well as in this case. See Item 21.j(7)(c) below.

Even if the personal liability exists only up to the value received by the beneficiary, the beneficiary must be careful to realize that there is potential personal liability for unpaid estate taxes up to that amount even if the value of the property received later declines in value.

(8) **IRS May Proceed Against Any Beneficiary or Trustee.** Within the limits applicable to any particular trustee or beneficiary, the IRS may proceed against any one or more of them to collect unpaid estate taxes. The person or persons tagged with having to pay the estate taxes could try to proceed against other estate beneficiaries in accordance with applicable apportionment provisions in the governing instruments or under state law.

(9) **Coordination With Other Personal Liability Statutory Provisions; Non-Probate Property Limitation in §6324(a)(2).** The IRS has a special estate tax lien for 10 years on estate property for the payment of estate taxes, §6324(a)(1). (The dissent discusses in its Section I.A the automatic estate tax lien and ways the government can protect itself during a §6166 deferral period that could last longer than the 10 years of the estate tax lien.)

If the government does not avail itself of those lien remedies, it can impose personal liability on certain persons. The government can impose personal liability on executors who make distributions during or causing insolvency. 31 U.S.C. §3713. It can also impose personal liability on "transferees" under §6901 and on six categories of persons identified in §6324(a)(2) regarding non-probate property. Certain limitations apply to personal liability under §6901, and the government can choose to assert personal liability under §6324(a)(2), for example if some of the limitations under §6901 would prevent the government from collecting tax under that section. For an excellent discussion of transferee liability under §6324(a)(2) as well as under §6901, see Scott St. Amand, *The Intersection of Estate Tax Deferral, Liens, and Transferee Liability, Part II: The Complex Consequences of Deferral of Estate Tax Under §6166*, 48 TAX MGMT. EST., GIFTS & TRSTS. J. No. 3 (May 11, 2023).

(a) **Section 6901 Limitations.** There are significant limitations on personal liability of transferees under §6901 that do not apply to §6324(a)(2).

Time Limitation on Assessment. Section 6901(c) provides that the period of limitations for assessment of transferee liability against an initial transferee is one year after the expiration of the period of limitation for assessment against the transferor. The IRS generally must assess tax against the estate within three years of the filing of the estate tax return (§6501(a)), so §6901(c) generally requires assessment against the transferee within four years after the return was filed. However, the three-year period for assessment of estate tax is suspended during any Tax Court proceeding or any extension period for the payment of tax under §6161(a)(2), §6161(b)(2), §6163, or §6166. §6503(a)(1); §6503(d).

Limit on Amount of Liability. For transferee liability under §6901, federal courts have generally held that the transferee's liability is limited to the value of the transferred assets on the date of transfer. *E.g., Commissioner v. Henderson's Estate*, 147 F.2d 619 (5th Cir. 1945). As discussed in *Paulson*, the personal liability under §6324(a)(2) is not clearly limited to the value received at the time of distribution. It is clear that interest on unpaid estate tax is subject to the transferee liability rules. However, the cases have not been consistent with respect to whether the limit on liability to the value of property at the time of the decedent's death applies to interest as well as the unpaid principal of the tax itself.

State Law Insolvency Analysis (But Not Required for Estate and Gift Tax Liability Under §6324(a)(2)). Section 6901 does not impose personal liability on a transferee. Generally, the IRS must establish a transferee's liability under state law (typically under "fraudulent transfer" principles if the transferor was insolvent at the time of the transfer or was rendered insolvent by the transfer); §6901 provides a remedy or procedure to be used by the IRS as a means of enforcing the liability. However, that is not the case for estate and gift tax if personal liability can be established under §6324(a)(2) (estate tax) or §6324(b) (gift tax). *See Poinier v. Commissioner*, 858 F.2d 917 (3d Cir. 1988), *cert denied*, 490 U.S. 1019 (1989) (insolvency of transferor was not a prerequisite for establishing transferee liability for unpaid

gift tax). Personal liability under those statutes may be enforced against a transferee under §6901.

(b) **Section 6324(a)(2) Personal Liability is Not Subject to Strict Four-Year Limitations Period.** Even if the IRS fails to assess a tax deficiency against beneficiaries within the general four-year period that would be allowed under §6901(c)(1) (keeping in mind that the assessment period is suspended during a Tax Court proceeding or when the tax is deferred under §§6161, §6163, or §6166), a transferee may nevertheless be liable for transfer taxes in some situations in which §6324(a)(2) applies. Various cases have reasoned that §6901(c) and §6324(a)(2) are "cumulative and alternative — not exclusive or mandatory." *E.g.*, *U.S. v. Kulhanek,* 106 AFTR 2d 2010-7263 (W.D. Pa. 2010) (collection action against transferees 17 years after date of death); *Estate of Mangiardi v. Commissioner*, T.C. Memo. 2011-24, *aff'd in unpublished opinion*, 108 AFTR 2d 2011-6776 (11th Cir. 2011) (collection against IRA beneficiary commenced eight years after IRA owner's death with no prior assessment against the beneficiary). Therefore, the IRS may proceed against a transferee under §6324(a)(2) even if an assessment is not made against the transferee within four years as generally required under the §6901(c) alternative.

(c) **Section 6324(a)(2) Applies Only to Recipients of Non-Probate Property; Applicability to Funded Revocable Trusts; *Paulson, Johnson*.** A significant limitation of personal liability under §6324(a)(2) is that it applies only to recipients of assets included in the decedent's gross estate under §§2034-2042. Are the assets in a funded revocable trust includable in the gross estate under §2036 or §2038 or merely under §2033? If the trust assets are included only under §2033, then §6324(a)(2) would not apply.

i. ***Paulson.*** The *Paulson* Ninth Circuit opinion does not address that issue, but the district court determined that the revocable trust assets were includable under §2038 and not §2033, so the trustee was therefore subject to personal liability for the estate tax §6324(a)(2) (despite a published Revenue Ruling to the contrary which the court did not discuss or even cite). 331 F. Supp. 3d 1066, 122 AFTR 2d 2018-5808 (S.D. Calif. 2018). The district court's only analysis of the §2033 vs. §2038 issue quotes from statements in *Estate of Tully v. United States*, 528 F.2d 1041 (Ct. Cl. 1976), that §2038 "taxes property which an individual has given away while retaining enough 'strings' to change or revoke the gift," while §2033 "is more general in its approach, and taxes property which has never really been given away at all." The district court concluded that the decedent's "ability to amend, revoke, or terminate the Living Trust triggers § 2038." Although the district court cited the 2018 district court case of *United States v. Johnson* (discussed below regarding another issue), it does not even mention that *United States v. Johnson* had a detailed analysis of the §2033 vs. §2038 issue for purposes of §6324(a)(2) and concluded that the revocable trust in that case was includable under §2033, so that §6324(a)(2) did not apply to the trustee of the trust. (The *Paulson* district court noted as to the other issue that *Johnson* was on appeal "and thus its conclusions are unpersuasive," but the appeal did not address the §2033 vs. §2038 issue for purposes of §6324(a)(2).) The *Paulson* district court case did not cite, let alone discuss, Rev. Rul. 75-553 that seemingly reached a contrary result (but addressed a revocable trust that passed to the decedent's estate at death rather than passing for the benefit of third parties).

ii. **Other Cases Applying §6324(a)(2) to Revocable Trusts.** Other cases have similarly stated that §6324(a)(2) applies to assets in revocable trusts without express analysis of the §2036-§2038 vs. §2033 issue. *E.g.*, *U.S. v. Allison, et al*, 587 F. Supp. 3d 1015, 129 AFTR 2d 2022-830 (E.D. Calif. 2022), *order adopting parties' stipulation for entry of judgment*, 131 AFTR 2d 2023-327 (E.D. Calif 2023); *Garrett v. Commissioner*, T.C. Memo. 1994-70 (beneficiary did not have discharge of indebtedness income from trustee's payment of estate taxes because the trustee, not the beneficiary, was personally liable for estate tax under §6324(a)(2)).

iii. ***United States v. Johnson.*** A prior district court case had held to the contrary, that the revocable trust assets were includable solely under §2033. *United States v. Johnson*, 224 F. Supp. 3d 1220, 118 AFTR 2d 2016-6781 (D. Utah 2016). *See* Rev. Rul. 75-553, 1975-2 C.B. 477 (trustee of revocable trust does not have personal liability for estate tax under §6324(a)(2) because revocable trust assets are includable only under §2033 and not §2036 or §2038 for a trust in which the decedent had retained all beneficial interests). *Johnson* referred to Technical Advice Memorandum 8940003, which addressed a transfer by "A" to a third party as trustee of a trust to be distributed as directed by A. The trust assets "were held solely for the benefit of A during A's lifetime and were payable to A's estate at A's death." The TAM concluded that the assets were includable in A's gross estate under §2033, not §2038.

The *Johnson* court also relied on Rev. Rul. 75-553, 1975-2 C.B. 477, to support the conclusion that §2033 applied, not §2038, for purposes of §6324(a)(2). In Rev. Rul. 75-553 the decedent transferred assets to a third party as trustee of a revocable trust that would be paid to the decedent's estate upon her death. Rev. Rul. 75-553 reasoned that §2036 - §2038

> do not become operative unless someone other than the decedent receives a beneficial interest in the transferred property. The transfer of property to a trustee acting as agent for the transferor, without a third party receiving any interest in the property, would not fall with the scope of section 2036, 2037, and 2038. In the instant case the trust corpus is payable to the decedent's estate and is property of the decedent within the meaning of section 2033 and is includible in the gross estate only under that section.

The court acknowledged that the trust in Rev. Rul 75-553 passed to the decedent's estate whereas the revocable trust in *Johnson* remained in trust for other beneficiaries. *Johnson* did not find that difference to be critical or even relevant.

> Additionally, the IRS was not focused on the fact that upon the Revenue Ruling decedent's death, trust assets were distributed to his estate, as opposed to a beneficiary or to a testamentary trust. It is true that here, Decedent's Trust arrangement meant that Trust assets avoided probate and allowed retention of control over a closely held business after Decedent's death. But Trust asset passage through probate—or any other after-death process or event—is not relevant to what beneficial ownership of the property the Decedent held during her lifetime. The court finds that these IRS interpretations of the Code and its regulations are reasonable and are entitled to substantial judicial deference.

224 F. Supp. 3d 1220, 118 AFTR 2d 2016-6781, at 6790-6791 (D. Utah 2016).

The *Johnson* court had originally found that §2036 and §2038 applied because "at the instant of death the beneficiaries in this property had a legally enforceable interest." *See id.* at 2016-6788. Upon reconsideration the court vacated that determination, reasoning that "Trust assets were never 'given away' such that Decedent lost the beneficial ownership of them during her lifetime, and thus that there was no transfer—incomplete or not—for purposes of sections 2036 and 2038 prior to Decedent's death." 224 F. Supp. 3d 1220, 118 AFTR 2d 2016-6781, at 6791 (D. Utah 2016). Therefore, the court concluded that the revocable trust assets were includable in the gross estate under §2033, which precluded the trustees from having personal liability for estate taxes under §6324(a)(2). This finding was strongly criticized by Professor Jeff Pennell. Jeffrey Pennell, *U.S. v. Johnson*, LEIMBERG EST. PL. NEWSLETTER #2497 (Jan. 10, 2017); *see also* Chuck Rubin, *U.S. v. Johnson: 3 Strikes Against the IRS in Attempting to Impose Fiduciary and Beneficiary Liability for Estate Taxes*, LEIMBERG EST. PL. NEWSLETTER #2496 (Jan. 10, 2017).

The district court subsequently awarded attorneys' fees and expert witness costs to the defendants. 121 AFTR 2d 2018-341 (D. Utah 2018). The court found that the government's position (regarding the §2033 vs. §2038 issue) was not substantially justified, **in part because of the failure to follow its own published guidance** in Rev. Rul. 75-553.

> While the defendants acknowledge that "the question of the proper code section of inclusion was a novel issue," …, the government's defense of this position merely restates their litigation position, without demonstrating why their position was reasonable.
>
> In particular, the government continues to assert that its "transfer" arguments were reasonable without addressing the court's conclusion that this position was inconsistent with the IRS statutory scheme and contradicted both IRS Technical Advice Memorandum 89-40-003 and IRS Revenue Ruling 75-553. *Johnson*, 224 F. Supp. 3d at 1232–34. 26 U.S.C. § 7430(c)(4)(B)(ii) provides that "the position of the United States shall be presumed not to be substantially justified if the Internal Revenue Service did not follow its applicable published guidance." Although the statute allows this presumption to be rebutted, the court concludes that the government's arguments fail to do so. Under the IRS statutory scheme, the only potentially applicable transfer sections (§§ 2036 and 2038) require beneficial ownership to have been given away while at the same time retaining some of the value of what has been given away. The government has not presented any factual or legal arguments that reasonably support a conclusion that Anna S. Smith divested herself of the beneficial ownership of her trust assets during her lifetime. Instead, its arguments directed the court's attention away from this critical fact. Because the government has not demonstrated that its position on trustee liability pursuant to 26 U.S.C. § 6324(a)(2) had a reasonable basis in fact or law, the defendants should be awarded attorney's fees for all aspects of their defense to these claims.

121 AFTR 2d 2018-341, at 344-45.

The Tenth Circuit heard an appeal, but only as to other issues. 920 F.3d 639, 123 AFTR 2d 2019-1272 (10th Cir. 2019). The government did not appeal as to whether §6324(a)(2) applied to funded revocable trusts.

iv. **Inconsistency With Rev. Rul. 75-553.** The IRS's published ruling position (Rev. Rul. 75-553) is that a revocable trust in which the decedent retained all beneficial interests and that passed to the decedent's estate at death is included in the gross estate under §2033, not §2036 or §2038, so §6324(a)(2) cannot apply. The IRS has claimed personal liability of trustees of funded revocable trusts under §6324(a)(2) seemingly in direct contravention of the holding of Rev. Rul. 75-553. What is the point of the IRS publishing its official position on issues in Revenue Rulings if taxpayers cannot rely on them? The Tax Court in *Rauenhorst v. Commissioner,* 119 T.C. 157 (1993), discussed in Item 20.b(8)(c) above, strongly criticized the IRS for taking positions contrary to published rulings.

> Respondent's counsel may not choose to litigate against the officially published rulings of the Commissioner without first withdrawing or modifying those rulings. The result of contrary action is capricious application of the law.

Arguably, however, the IRS is not taking inconsistent positions as to revocable trusts that are not paid to the decedent's estate following the decedent's death. The *Johnson* district court expressly rejected that distinction (and awarded litigation costs against the government in part of because of the IRS's failure to follow Rev. Rul. 75-553), but the IRS could legitimately take the position that such a distinction is appropriate. Professor Pennell believes that the distinction is very important. Jeffrey Pennell, *U.S. v. Johnson*, LEIMBERG EST. PL. NEWSLETTER #2497 (Jan. 10, 2017).

v. **Conclusion.** If future courts side with *Johnson* (which is consistent with Rev. Rul. 75-553), many of the concerns raised by *Paulson* would disappear (keeping in mind that §6324(a)(2) personal liability does not apply to probate property or property includable in the estate only under §2033). However, the concerns presumably would still be applicable to beneficiaries of IRAs or life insurance, trusts that are includable in the gross estate under §2035, or assets of limited partnerships or LLCs that are includable in the gross estate under §2036 or §2038.

24. Purchase Agreement Not Respected for Valuation Purposes under Section 2703, *Huffman v. Commissioner,* T.C. Memo. 2024-12

a. **Synopsis.** Chet Huffman, son of donors, entered into an agreement in 1993 with a trust funded by donors (the trust presumably was a revocable trust) and an agreement with an S corporation owned

entirely by his mother giving him an option to purchase the shares of a Company that manufactured and supplied engineering components to the aerospace industry (the "RTP agreements"). Chet had become the CEO of the Company six years earlier (when his father, who was the prior CEO, had a near fatal off-road racing accident [he was a member of the Off-Road Motorsports Hall of Fame]). The RTP agreements gave Chet the right to acquire the shares for a price not to exceed $3.6 million and $1.4 million, respectively, at the deaths of his parents or under a right of first refusal. An addendum gave Chet the right to acquire the shares at any time but required consent from various people to override alienability restrictions. The Company would have to increase in value by a very large amount, from about $0.49/share to $11.83/share (2,314%!) [i.e., increase of $11.83 - $0.49 = $11.34; and 11.34/0.49 = 23.14, or 2,314%] before the shares would be "in the money." Chet exercised the right to purchase the shares in 2007, paying the $5 million with a note.

No 2007 gift tax return was filed. The accountant never suggested to Chet's parents there was potential gift tax liability or the need to file a gift tax return. At some point, the IRS argued that a gift was made from the parents in 2007 when Chet purchased shares that were worth more than the $5 million exercise price.

The court determined that the burden of proof did not shift from the donors to the IRS. A 5%-6% reduction in the IRS's valuation position at trial as compared to the notice of deficiency was not enough to shift the burden of proof.

The court found that §2703 applied, so the agreement could not "be respected for valuation purposes." The first two elements of the safe harbor in §2703(b) were satisfied, but the third was not. (1) The parties agreed the agreement had a valid business purpose (maintaining managerial control or family ownership). (2) The agreement was not a testamentary device to transfer property to members of the family for less than full consideration because Chet paid adequate consideration for the option agreements (taking into consideration reduced compensation he received as CEO) and because the "unusual" level of growth suggested the agreement was meant to incentivize Chet rather than to transfer property to him for less than full value. (3) The third requirement, that the terms of the agreement were comparable to similar arrangements entered into in an arm's length transaction, was not satisfied. A suggested comparable arrangement was not comparable, in part because of procedural issues (the other agreement was not entered into evidence). Even aside from the evidentiary issue, the other agreement was not comparable largely because Chet's agreement could be exercised at any time but the other could be exercised only at a person's death or under a right of first refusal.

The court reviewed the opinions of the parties' experts (government's expert at $31.3 million and taxpayers' expert at $16.3 million as the value of the purchased shares) and determined that the IRS's appraisal was more appropriate (with several revisions), so the gift was the difference between the appraised value (as adjusted) and the $5 million paid by Chet in exercising the option. (The adjustments to the position of the government were not clear from the opinion but may have been as much as $10 million.) The IRS's expert opinion concluded that a 10% lack of control and 20% lack of marketability discount were appropriate.

The court also addressed income tax issues (for example, in one transaction the parties overvalued the portion of sale proceeds from a subsequent sale of assets by the corporation and affiliated entities that were allocated to goodwill, and correcting that resulted in increased capital gain to the corporation and a constructive dividend to the taxpayers.) The court also addressed accuracy-related penalties under §6662 and failure to file and pay penalties under §6651. The court determined that the reasonable cause exception applied (except for one conceded matter) because of reasonable reliance on professional advice, so penalties generally were not applicable. *Huffman v. Commissioner*, T.C. Memo. 2024-12 (January 31, 2024) (Judge Ashford).

b. **Burden of Proof.** The court determined that the burden of proof did not shift from the donors to the IRS. *See* §7491(a). The taxpayers argued that the burden of proof should shift to the IRS because the asserted valuation at trial was less than in the notices of deficiency. The court considered prior cases holding that the IRS forfeits the presumption of correctness by conceding the assessed deficiency was erroneous (*Estate of Simplot*) and that the IRS had assumed the burden of proof by be reducing

the alleged valuation at trial by 19%, which caused the court to find that the initial assessment was "arbitrary and excessive" (*Estate of Mitchell*). The court determined that the 5%-6% reduction at trial in this case did not mean the initial valuation was "arbitrary and excessive."

The burden of proof determination was important because the court did not base its decision on a preponderance of the evidence, but the donors "failed to meet the burden of proof regarding why their expert's valuation is correct."

c. **Section 2703.** The court found that §2703 applied, so the agreement could not "be respected for valuation purposes."

Section 2703(a)(1) provides that the value of any property must be determined without regard to "any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right)." Section 2703(b) provides an exception to §2703 for any agreement that meets all of three listed requirements. The first two elements of the safe harbor in §2703(b) were satisfied, but the third was not.

(3) **Business Purpose Test.** The parties agreed that the agreement had a valid business purpose (maintaining managerial control or family ownership was an appropriate purpose).

(4) **Device Test.** The agreement was not a device to transfer property to members of the family for less than full consideration. The court gave two reasons. First, one factor is "the fairness of the consideration received by the transferor when it executed the transaction" (citing *Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60, and *Estate of True v. Commissioner*, T.C. Memo. 2001-167). The court concluded that Chet paid adequate consideration when he entered into the option agreements (taking into consideration reduced compensation he received as CEO). Second, the court noted the "unusual and unexpected" huge level of growth required before the agreement would be exercised, which "incentivized Chet both to stay with the company and to increase its per-share value," and which suggested the agreement was not intended to transfer shares to him for less than full consideration. (The court did not mention the conclusion in *Kress v. U.S.*, 123 AFTR 2d 2019-1224 (DC Wis. 2019), that the reference in §2703(b)(2) to "members of the decedent's family" means that the device test applies only to transfers at death and not to inter vivos transfers.)

(5) **Comparability Test.** The third requirement, that the terms of the agreement were comparable to similar arrangements entered into by persons in an arm's length transaction, was not satisfied.

The court noted that the §2703(b) exception is "more of a safe harbor than an absolute requirement that multiple comparables be shown" (quoting *Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60) and that an "isolated comparable" can be used to satisfy the comparability test (citing *Estate of Amlie v. Commissioner*, T.C. Memo. 2006-76).

The donors pointed to a somewhat similar agreement with an unrelated party regarding the Company's stock. An agreement entered into in 1990 (the "Lloyd-Barneson agreement") gave Chet's father (Lloyd) the right to purchase shares in the Company owned by Barneson, an unrelated shareholder, for a price not to exceed a certain amount, which could be exercised at Barneson's death or under a right of first refusal. The father assigned his rights under that agreement to Chet in 1993, and later that year Chet and Barneson agreed that Chet would buy his shares for $150,000. The Lloyd-Barneson agreement was presented as a "comparable arrangement." The taxpayers pointed out various similarities with RTP agreement, including: (1) a right to purchase on the death of the grantor and by a right of first refusal; (2) a maximum purchase price; and (3) no specific termination or exercise date. The court determined that this other agreement was not comparable partly on procedural grounds because the Lloyd-Barneson agreement had not been introduced as evidence. Even aside from the evidentiary issue, the court noted some provisions that made Chet's agreement less valuable (he had to obtain more consents to transfer his purchase rights), but others that made it more favorable (he could exercise it any time rather than just at death or upon a right of first refusal). Those differences were enough to make it not comparable. The court cited *Estate of Blount v. Commissioner*, T.C. Memo. 2004-116 (finding that solely testimony without production of comparable agreements

was insufficient to satisfy §2703(b)(3)), *aff'd in part, rev'd in part and remanded*, 428 F.3d 1338 (11th Cir. 2005).

d. **Ultra-Strict Comparability Analysis.** The *Huffman* analysis seems remarkably strict in its application of the comparability test (aside from the procedural evidentiary issues). Look at the similarities between the RTP agreement and the comparable agreement with the unrelated third party, Barneson:

- Both agreements involved the exact same Company.
- Both agreements involved an option-to-purchase arrangement rather than a mandatory purchase.
- Both agreements allowed the person holding the option to exercise a right of first refusal if someone else wanted to buy the stock.
- Both agreements would extend through the deaths of the sellers.
- Both agreements were signed in the same general time frame. Chet negotiated to purchase shares from the third party (presumably using the framework of the 1990 Lloyd-Barneson agreement and the price at which Chet knew he could purchase Barneson's shares at his death) in August 1993, and Chet entered into the RTP agreement in November 1993.
- Both agreements were transferable, but Chet's agreement required that he get more consents than in the comparable agreement.
- Neither agreement involved put rights, drag along rights, or tag-along rights.

As buy-sell agreement go, that's a **lot** of similarities.

The big difference the court latched onto was that Chet could exercise his option under the RTP agreements at any time whereas the comparable was exercisable only at the death of Barneson or in the exercise of a right of first refusal. But this arrangement under the RTP agreements was one where the option was not going to be exercised in any event for a considerable length of time. There would be no reason to exercise the option until the company had grown by 23 times its value!! (The IRS's expert valued the shares at $0.51/share. Even in that expert's view, the company would have to grow by 22 times before it would be "in the money" [$11.83 - $0.51 = $11.32; $11.32/$0.51 = 22.20, or 2,220%].) The court observed that based on the assumptions of Chet and Barneson in their arm's length negotiation in 1993, "the RTP agreements would have taken between 50 and 70 years to reach an 'in the money' value." Chet's parents would have both died within that 50-70 year time frame. Even if the RTP agreements had been exercisable only at death, the expectation at the time they signed the agreements was that they would not have been exercised before that time anyway. In that respect, the timing of purchases under the two agreements was not that different.

The big difference, in terms of comparability, would seem to be the price terms, but the court expressed no concern over pricing differences between the two agreements. The court also did not express any concern with whatever differences may or may not have existed between the payment terms.

The court could have based its decision on the evidentiary issue, and that would have been totally understandable. But to base its decision in part on the lack of comparability with the Barneson agreement is hard to fathom. It's almost as if the only way to satisfy the comparability test is to come up with an agreement involving the same company for exactly the same terms. That flies in the face of statements in the §2703 regulations. *E.g.*, Reg. §25.2703-1(b)(4)(i) ("if it conforms with the general practice of unrelated parties under negotiated agreements in the same business"); §25.2703-1(b)(4)(ii) ("a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods. It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement."). And the legislative history similarly anticipated the use of a much more reasonable comparability standard. This is from the Conference Report:

> The conferees do not intend the provision governing buy-sell agreements to disregard such an agreement merely because its terms differ from those used by another similarly situated company. The conferees recognize that general business practice may recognize more than one valuation methodology, even within the same industry. In such situations, one of several generally accepted methodologies may satisfy the standard contained in the conference agreement.

At the time the option was exercised by Chet, the Company had grown tremendously (under *his* leadership, not because of what the parents did), and the price per share was much higher than under the option agreement. How could anyone have anticipated that dramatic growth when the RTP option agreements were entered? But it's as if the court was convinced a gift tax should apply when a transfer is made with that big of a valuation disparity between the current value and option price and was looking to find SOME reason not to be bound by the lower price in the option agreement. To reach that conclusion, the court latched onto a pretty small difference between otherwise very similar option agreements.

e. **Section 2703(b) Analysis Consistent With Various Other Cases Regarding Comparability Analysis.** Unfortunately, the *Huffman* court is following the trend of cases that have applied the comparability test strictly in requiring examples or evidence of actual comparable arrangements negotiated at arm's length. *E.g.*, *Connelly v. United States of America, Department of the Treasury, Internal Revenue Service*, 128 AFTR 2d 2021-5955 (E.D. Mo. 2021), *aff'd*, 131 AFTR 2d 2023-1902 (8th Cir. June 2, 2023), *aff'd on other grounds, 602* U.S. __ (2024) (estate "failed to prove any evidence of similar arrangements negotiated at arms' length" [about determining the purchase price without including life insurance proceeds received by company at decedent's death]); *Kress v. United States*, 123 AFTR 2d 2019-1224 (E.D. Wi. 2019) ("Though Plaintiffs contend *restrictions* like the Kress Family Restriction are common in the commercial world, they have not produced any evidence that unrelated parties at arms' length would agree to such an arrangement."); *Estate of Blount v. Commissioner*, T.C. Memo. 2004-116, *aff'd in part, rev'd in part*, 428 F.3d 1338 (11th Cir. 2005) ("He did not present evidence of other buy-sell agreements or similar arrangements, where a partner or shareholder is bought out by his coventurers, *actually entered into* by persons at arm's length. … Because Mr. Grizzle has failed to provide any evidence of *similar arrangements actually entered into* by parties at arm's length, as required by section 2703(b)(3), and his opinion is based solely on his belief that the purchase price for decedent's BBC shares was set at fair market value, Mr. Grizzle's conclusion that the terms of the Modified 1981 Agreement are comparable to similar agreements entered into by parties at arm's length is unsupportable."); *Smith v. Commissioner*, 94 AFTR 2d 2004-5283 (W.D. Pa. 2004) ("In this case, both parties concede that it would be inherently difficult to find an agreement between unrelated parties dealing at arm's length that would be comparable to a family limited partnership, which, by its terms, is restricted to related parties. … Nevertheless, Plaintiffs have submitted the affidavits of two attorneys … who essentially state that restrictive provisions requiring installment payments and charging interest at the applicable federal rate are common in both family limited partnerships and transactions involving unrelated parties. … Upon review, these affidavits merely state opinions that are conclusory in nature and do not constitute evidence sufficient to dispel any genuine issue of material fact as to whether of [*sic*] the restrictive provision in the Smith FLP agreement meet the test set forth in Section 2703(b)(3).")

The comparability test was satisfied in *Amlie v. Commissioner*, T.C. Memo. 2006-7, involving a rather complicated fact pattern. The court concluded that an agreement met the comparability test because it was based on price terms in an earlier agreement, which was based on a survey of comparables.

25. Valuation of Life Insurance Policies, *M. Joseph DeMatteo v. Commissioner,* Tax Court Docket No. 3634-21 (Stipulated Decision Feb. 22, 2024)

a. **Background.** A recent 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 reference to sales 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 [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.

b. **Basic Facts.** In *DeMatteo v. Commissioner*, Tax Court Docket No. 3634-21 (Petition filed April 9, 2021), the donor hired an independent professional consultant, 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, was 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."

c. **Settlement.** A stipulated decision entered Feb. 22, 2024, reports an agreed gift tax deficiency of $4,291,077. Presumably, the parties offered additional evidence of the values of the policies and eventually agreed on stipulated values of the policies.

From a planner's perspective, the settlement is disappointing. If the court in this case had ultimately decided on an appropriate approach for valuing the policies, the case could have been quite instructive regarding the valuation of life insurance policies for transfer tax purposes.

26. Reverse Split Dollar Life Insurance, *Cinader v. Commissioner*, Tax Court Docket No. 13491-22 to 13496-22 & 5245-22 (Stipulated Decision Jan. 3, 2024)

a. **Background.** Under a traditional split dollar arrangement, the insured donor pays premiums on life insurance policies owned by a trust. At the insured's death, the insured receives back certain amounts, but the trust receives the balance of the death proceeds. Table 2001 rates may be used for valuing the pure insurance coverage.

Under a reverse split dollar arrangement, an irrevocable trust owns the policy and the insured pays for the right to designate who receives the death proceeds. In *Cinader v. Commissioner,* Tax Court Docket No. 13491-22 to 13496-22 & 5245-22, the insured used the Table 2001 rates to determine the amount paid annually (with a note) to be able to designate the beneficiary in that year (even though, as discussed below, an IRS Notice says the Table 2001 rates cannot be used in the reverse split dollar situation).

e. **Basic Facts.** An irrevocable trust owned a life insurance policy on the insured's life. The insured agreed to pay the trust (with notes) for the right to designate the beneficiary (of death proceeds minus the greater of the cash surrender value or the premiums paid). The Table 2001 rates were used to determine each year's repayment amount. The insured owed the trust $41,168,849 at his death, which amount was deducted on the estate tax return.

The IRS's position was that Table 2001 rates cannot be used to value the pure insurance coverage when the insured does not own the policy. Notice 2002-59. (Table 2001 rates often exceed actual premium amounts.) In *Cinader*, the IRS maintained (i) that the insured made gifts to the trust each year when using the Table 2001 rates to determine the payment amount, (ii) that the insured's debts (the notes) to the trust were not bona fide indebtedness, and (iii) that the debts were therefore not deductible for estate tax purposes under §2053.

f. **Settlement.** A stipulated decision was entered January 3, 2024, reporting agreed gift tax deficiencies of $3,327,230 for 2002, $99,213 for 2003, $1,424,814 for 2012, $8,433,707 for 2013, $1,527,836 for 2015 (total gift tax efficiencies of $14,812,800) and an estate tax deficiency of $14,298,629.

27. Administrative Procedure Act; Tax Court Reverses Course and Invalidates Conservation Easement Regulation Under APA, *Valley Park Ranch, LLC et al. v. Commissioner*, 162 T.C. No. 6 (March 28, 2024); Invalidity under APA of Notice 2017-10, *Green Rock, LLC v. Internal Revenue Service et al*, 133 AFTR 2d 2024-1630 (11th Cir. June 4, 2024)

a. **Brief Background; *Hewitt* and *Oakbrook Land Holdings*.** Cases have split in the last several years regarding the validity of a conservation easement regulation under the Administrative Procedure Act (APA). Taxpayers have argued that the "protected in perpetuity" requirement in the conservation easement extinguishment proceeds regulations is invalid to the extent that it disallows the subtraction of the value of post-donation improvements in determining the portion of extinguishment proceeds attributable to the easement, reasoning that the "notice-and-comment" procedures in the APA were not followed because the Treasury "did not discuss or respond to comments by … commenters concerning the extinguishment proceeds regulations." *Hewitt v. Commissioner*, 21 F.4th 1336, 128 AFTR 2d 2021-7033, at 2021-7039 (11th Cir. 2021). The Tax Court rejected that argument in *Oakbrook Land Holdings, LLC, et al. v. Commissioner*, 154 T.C. 180 (2020), and about a month later in *Hewitt v. Commissioner*, T.C. Memo. 2020-89.

Hewitt was reversed by the Eleventh Circuit in 2021. *Hewitt v. Commissioner*, 21 F.4th 1336, 128 AFTR 2d 2021-7033, at 2021-7039 (11th Cir. Dec. 29, 2021). The opinion observed that 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.'" The opinion quoted extensively from Judge Toro's concurring opinion in the Tax Court's opinion in *Oakbrook Land Holdings* regarding the failure of the regulation to comply with the APA regarding its treatment of post donation improvements under the extinguishment provision.

Oakbrook Land Holdings was affirmed about two and a half months later by the Sixth Circuit. *Oakbrook Land Holdings, LLC. V. Commissioner*, 28 F.4th 700, 129 AFTR 2d 2022-1031 (6th Cir. 2022), *cert. denied*, 143 S. Ct. 626 (2023). The Sixth Circuit Court of Appeals affirmed the Tax Court and upheld the validity of the extinguishment proceeds 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 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 extinguishment proceeds 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, but it was denied. 143 S. Ct. 626 (2023).

b. **Synopsis of *Valley Park Ranch*.** The Tax Court, in a reviewed opinion, reversed course from its prior positions in *Hewitt* and *Oakbrook Land Holdings*, coming to the conclusion that the extinguishment proceeds provision in the regulations was invalid. *Valley Park Ranch, LLC et al. v. Commissioner*, 162 T.C. No. 6 (March 28, 2024). Even though *Oakbrook Land Holdings* was affirmed by the Sixth Circuit, the Tax Court found the reasoning of the Eleventh Circuit in *Hewitt* to be more convincing. The *Valley Park Ranch* opinion generally follows the reasoning of the Eleventh Circuit's opinion in *Hewitt*.

> After a public hearing, Treasury adopted the proposed regulations with revisions. T.D. 8069. In the preamble to the final rulemaking, Treasury stated that "[t]hese regulations provide necessary guidance to the public for compliance with the law and affect donors and donees of qualified conservation contributions" and that it had "consider[ed] . . . all comments regarding the proposed amendments." *Id.* In the subsequent "Summary of Comments" section, however, Treasury did not discuss or respond to the comments made by NYLC or the other six commenters concerning the extinguishment provision. …
>
> Upon careful consideration of the Eleventh Circuit's analysis in *Hewitt* regarding the promulgation of the proceeds regulation, we are persuaded that Treasury's actions did not provide "an explanation [that] is clear enough that its 'path may reasonably be discerned.'" …
>
> We agree with the Eleventh Circuit's conclusion that "NYLC's comment was significant and required a response by Treasury to satisfy the APA's procedural requirements." …
>
> …
>
> NYLC expressly tied its comments both to a specific rule included in the proposed regulations and to a specific fact pattern contemplated by the proposed regulations. *Hewitt v. Commissioner*, 21 F.4th at 1348 (citing *Oakbrook I*, 154 T.C. at 224 (Toro, J., concurring in the result)). Thus, NYLC explained why the regulation contained "problems of policy and practical application" and therefore "*strongly* recommend[ed] deletion of the entire extinguishment provision." *Id.* at 1345 (alteration in original); *see supra* pp. 16-17. We therefore follow the Eleventh Circuit and hold that those comments were both "relevant and significant," requiring a response. …
>
> …
>
> In *Oakbrook I*, 154 T.C. at 194, the opinion of this Court rejected the argument that Treasury did not comply with the APA because the preamble "did not discuss the 'basis and purpose' of the judicial extinguishment provision specifically." *See Hewitt v. Commissioner*, 21 F.4th at 1347. The majority opinion reasoned that "[e]ven where a regulation contains no statement of basis and purpose whatsoever, it may be upheld 'where the basis and purpose . . . [are] considered obvious.'" *Oakbrook I*, 154 T.C. at 194 (alteration in original) (quoting *Cal-Almond, Inc. v. USDA*, 14 F.3d 429, 443 (9th Cir. 1993)); *Hewitt v. Commissioner*, 21 F.4th at 1347-48. But as the Eleventh Circuit subsequently explained in *Hewitt*, "[b]asis and purpose statements must enable the reviewing court to see the objections and why the agency reacted to them as it did" and that agencies should rebut relevant comments….
>
> …
>
> In agreement with the Eleventh Circuit's reasoning in *Hewitt v. Commissioner*, 21 F.4th at 1350-53, we hold that Treasury Regulation §1.170A-14(g)(6)(II) is procedurally invalid under the APA because Treasury failed to respond to a significant comment. Accordingly, we set it aside.

A concurring opinion by one judge agreed with the result of the case but did not believe the court needed to address the validity of the regulation to reach that result.

A dissenting opinion by Judge Kerrigan, joined by three additional judges, stated the court did not have to address the validity of the regulation to resolve the motion for summary judgment, expressed that the Tax Court's decision in *Oakbrook Land Holdings* upholding the regulation was correct and there was no compelling reason to change its position, and cited the long-standing principle of *stare decisis* in support of that position.

c. **Effect on Subsequent Cases.** The *Valley Park* opinion specifically noted that an appeal of the case would lie in the U.S. Court of Appeals for the Tenth Circuit, so the court is "not bound to follow either the decision of the Sixth Circuit in *Oakbrook II* (upholding the regulation) or that of the Eleventh Circuit in *Hewitt* (invalidating the regulation). *See Golsen*, 54 T.C. at 757." In future cases regarding the validity of the extinguishment proceeds regulation regarding post-donation improvements, the

Tax Court will follow *Oakbrook Land Holdings* in cases appealable to the Sixth Circuit, but otherwise will find that the regulation is invalid.

d. **Invalidity of Notice 2017-10, *Green Rock, LLC vs. Internal Revenue Service*.** Tax Court's held in *Green Valley Investors, LLC v. Commissioner*, 159 T.C. 80 (2022) (Reviewed by the Court) that prior Notices describing listed transactions did not comply with the Administrative Procedure Act. The Eleventh Circuit has ruled similarly in affirming an Alabama district court decision. *Green Rock, LLC v. Internal Revenue Service et al*, No. 23-11041 (11th Cir. June 4, 2024) (issuance of Notice 2017-10 labeling certain syndicated conservation easement deals as listed transactions was in violation of the APA; ruling does not address validity of listed transaction designations other than Notice 2017-10), *aff'g* 131 AFTR 2d 2023-562 (N.D. Ala. February 2, 2023). (Final regulations were released October 7, 2024, (TD 10007, RIN 1545-BQ39) treating conservation easements as listed transactions.)

e. **Effect on Analysis of Validity under the APA of Other Regulations.** Commentators have observed that this history suggests that courts are increasingly open to challenges of regulations under the APA and that taxpayers should examine substantive and procedural challenges to regulations. Treasury will likely be more meticulous in documenting its consideration of significant comments to proposed regulations.

> The decision is another indication that courts are increasingly open to Administrative Procedures Act challenges to Treasury regulations and highlights the importance of making comments on proposed regulations and considering APA challenges in tax litigation.
>
> …
>
> Practitioners and taxpayers should be encouraged to examine both substantive and procedural challenges to Treasury regulations in their tax controversies, as courts are increasingly open to laying regulations aside.
>
> Taxpayers, meanwhile, should note that substantive comments to proposed regulations are worth making, especially those joined by others in affected industries and those that use specific examples and hypotheticals.
>
> The Treasury may take note of this and similar future rulings, spurring more meticulous consideration of significant comments and giving them a bigger impact on final regulations. If comments aren't addressed or considered, taxpayers have yet another avenue for challenging regulations in future litigation.

Starling Marshall, *Conservation Easement Ruling Signals More APA Challenges Ahead*, BLOOMBERG DAILY TAX REPORT (April 2, 2024).

f. **Further Discussion.** For further discussion of cases addressing the validity of regulations under the APA, see Item 17 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**. See Item 30 below for a summary of *Loper Bright Enterprises v. Raimondo*, the 2024 Supreme Court decision rejecting the *Chevron* doctrine regarding the validity of regulations addressing ambiguous statutory provisions.

28. Treatment of Advances to Son as Legitimate Loans vs. Gifts, *Estate of Bolles v. Commissioner*, 133 AFTR 2d 2024-1235 (9th Cir. April 1, 2024) (unpublished opinion), *aff'g per curiam*, T.C. Memo. 2020-71.

a. **Synopsis.** The Tax Court addressed whether advances from a mother to her children (and particularly, over $1 million of advances to a struggling son) were legitimate loans or were gifts. Although the mother documented the advances, there were no loan agreements, security, or attempts to force repayment. She forgave the "gift tax exemption amount" of the debts each year. Large amounts were advanced to a struggling son ($1,063,333 over 23 years), and at some point, the mother realized that the son would never be able to repay the advances; on October 27, 1989, she prepared her revocable trust to exclude that son from any distribution of her estate at her death. The Tax Court treated advances through 1989 as loans but treated subsequent advances as gifts. *Estate of Bolles v. Commissioner*, T.C. Memo. 2020-71 (June 1, 2020, Judge Goeke). The Ninth Circuit Court of Appeals has affirmed in an unpublished per curiam opinion. *Estate of Bolles v. Commissioner*, 133 AFTR 2d 2024-1235 (9th Cir. April 1, 2024) (unpublished opinion).

b. **Basic Facts.** A mother generally wanted to treat her five children equally. She made advances to her children, keeping records of the advances and "occasional repayments for each child," but there were no notes, no collateral, and no attempts to force repayment. She treated the advances as loans, but she "forgave the 'debt' account of each child every year on the basis of the gift tax exemption amount." The court observed that "[h]er practice would have been noncontroversial but for the substantial funds she advanced to Peter."

Peter was the oldest of the children. He took over his father's architecture practice. He experienced success in attracting clients but had financial difficulties largely because his expectations exceeded realistic results. A family trust became liable for $600,000 of his bank loans. Because of his financial difficulties, the mother advanced substantial funds ($1,063,333) to Peter from 1985 through 2007.

The mother prepared a revocable trust dated October 27, 1989 that "specifically excluded Peter from any distributions of her estate upon her death." She subsequently amended the revocable trust to permit Peter to share in her estate but only after accounting for "loans" made to him plus accrued interest. Peter signed an acknowledgement that $771,628 plus accrued interest using the AFR for short-term debt determined at the end of each calendar year, would be subtracted from Peter's share of the estate at the mother's death.

Presumably, the mother forgave some of the advanced amounts to Peter under her annual gift plan, and Peter apparently made some repayments on the loans through 1988, but the IRS asserted that the entire $1,063,333 amount, plus $1,165,778 of accrued interest, was an asset of the mother's gross estate or that $1,063,333 was an adjusted taxable gift to be included in computing her estate tax liability.

c. **Tax Court Analysis.** The court observed the nine factors listed in *Miller v. Commissioner*, T.C. Memo. 1996-3, *aff'd*, 113 F.3d 1241 (9th Cir. 1997) as traditional factors for determining whether an advance is a loan or a gift. The court observed that the mother had recorded the advances and kept track of interest, but there were no loan agreements, collateral, or attempts to force repayment. A critical factor to the court was "that the reasonable possibility of repayment is an objective measure of [the mother's] intent." Peter's creative ability as an architect and ability to attract clients likely convinced the mother that he would be successful and "she was slow to lose that expectation." But she must have realized he would be unable to repay her loans by October 27, 1989, when her revocable trust blocked Peter from receiving additional assets from her at her death.

The court concluded that advances to Peter were loans through 1989 but after that were gifts. Also, the court "considered whether she forgave any of the prior loans in 1989, but [found] that she did not forgive the loans but rather accepted they could not be repaid on the basis of Peter's financial distress."

d. **Court of Appeals Analysis.** The Ninth Circuit Court of Appeals affirmed in a short per curiam opinion (unpublished). The court reasoned that the mother had made loans to her husband over the years for his architecture practice, and they were always repaid. The mother could reasonably assume that loans made to Peter for the business would similarly be repaid, and the advances from 1985 through 1989 were loans. However, the advances after 1989 were gifts. The court reasoned–

> Unlike the payments from 1985 through 1989, the payments after 1990 were made under different circumstances. First, unlike the early years of Mary's payments to Peter, there is no evidence that Peter made any repayments during this period. Second, in late 1989, Peter was specifically excluded from Mary's personal trust. And third, Peter signed an agreement acknowledging that "he has neither the assets, nor the earning capacity" to make repayments. It was reasonable for the Tax Court to conclude that there was no bona fide creditor-debtor relationship between Mary and Peter during this period, and accordingly that the payments from 1990 through 2007 were gifts.

e. **Planning Observations.** For a discussion of planning observations, including the general analysis of when advances are treated as resulting in bona fide loans and a discussion of various transfer tax related contexts in which the loan issue may arise, see Item 25 of Estate Planning Current Developments and Hot Topics (December 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

29. QTIP Trust Planning; Unanimous Reviewed Tax Court Opinion Rejecting a Section 2519 Argument the IRS Has Been Making With Increasing Frequency, *Estate of Anenberg v. Commissioner*, 162 T.C. No. 9 (May 20, 2024)

a. **Synopsis.** The Tax Court, in a unanimous reviewed opinion, rejected an attack on Qualified Terminable Interest Property (QTIP) trust planning that the IRS has been making with increasing intensity in recent years. Assets in QTIP trusts (including their future appreciation) will eventually be subject to transfer tax. One planning approach is to move trust assets into the hands of the spouse-beneficiary by distributions to the spouse or by the exercise of a power of appointment in favor of the spouse (see Reg. §25.2519-1(e)), who can then engage in traditional transfer planning alternatives. If the distribution standards are not broad enough to allow direct distributions of assets to the spouse by the trustee or if the trust does not give someone the power to appoint assets to the spouse, an approach that has been used by some planners is to obtain a judicial termination of the trust, resulting in all the trust assets being distributed to the spouse (with the consent of trust remainder beneficiaries). That is the situation addressed by the Tax Court in *Anenberg v. Commissioner*, 162 T.C. No. 6 (May 20, 2024).

QTIP trusts created for the surviving wife (W) by her deceased husband (H) at his death in 2008 were terminated by a state court and all trust assets were distributed to W (with the consent of the remainder beneficiaries, H's sons by a prior marriage) in March 2012. The assets included almost half the stock of a closely held company (Company). In August 2012, W gave about 6.4% of the stock she received from the QTIP trusts to trusts for H's sons. In September 2012, W sold almost all the remaining stock of the Company to trusts for H's sons and grandchildren in return for nine-year secured and partially guaranteed promissory notes bearing interest at the applicable federal rate.

W timely filed a gift tax return for 2012 reporting the August 2012 gifts to the sons and reporting the September 2012 sales as non-gift transactions. W died before the IRS's examination of the 2012 return was completed, and the IRS proceeded with its gift tax claims against W's estate.

The IRS claimed that W owed more than $9 million of gift tax (and a penalty of $1.8 million) under two theories: (i) the termination of the QTIP trusts was a disposition of W's qualifying income interest resulting in a gift under §2519; or (ii) the termination of the QTIP trusts and W's subsequent sale of the stock received from the QTIP trusts resulted in a deemed transfer under §2519. Section 2519 provides generally that a disposition of any portion of the spouse's "qualifying income interest for life" is treated as a transfer of all the remainder interest in the trust.

The Tax Court unanimously rejected both positions (granting W's estate's motion for partial summary judgment and rejecting the IRS's motion for partial summary judgment). The court's analysis was grounded in its view of the "QTIP Regime" to defer transfer taxation for assets passing to a QTIP trust until the death of or gift by the surviving spouse," which is effectively "a legal fiction under which the surviving spouse is treated as receiving all of the QTIP passing from the deceased spouse." Opinion at 4. With this backdrop, the court reasoned: (i) no gift occurred at the termination of the QTIP trusts when the assets were distributed to W, because even if a "transfer" occurred under §2519, no gift resulted because W ended up owning all of the trust assets; and (ii) no deemed transfer under §2519 applied upon the sale of the assets because following the termination of the QTIP trusts, the qualifying income interest for life terminated, and there could be no disposition of something that did not exist.

The court distinguished cases, regulation examples, and rulings cited by the IRS, because they involved situations in which the spouse received nothing in return for the disposition of the income interest or received only the value of the income interest. The result in those cited situations "resulted in one-time taxation of the value of the remainder interests." In contrast, under the *Anenberg* facts, the spouse received all of the trust assets outright, which would subsequently be subject to transfer tax, resulting in double-taxation if a current gift tax on the value of the remainder interest was also imposed under §2519.

The court did not address whether a different result would occur if the trust termination and sale were part of an integrated transaction (the court noted that the IRS did not argue that the "substance

over form" doctrine applied) (see Opinion at 25). Also, in footnote 18 the court expresses no view on whether H's sons made a gift by consenting to the termination and distribution to W of all trust assets. (That issue is addressed in, *McDougall v. Commissioner* 163 T.C. No. 5 (Sept. 17, 2024), discussed in Item 28 below, the same case in which the IRS had expressed its litigating position in CCA 202118008.) In addition, footnote 3 clarifies that because the court determined that no gifts resulted under §2519, the court did not have to address whether adequate disclosure had been made on the 2012 gift tax return such that the assessment of additional gift tax was barred by limitations.

Estate of Anenberg v. Commissioner, 162 T.C. No. 9 (May 20, 2024) (Judge Toro, with all judges in agreement).

b. **Basic Facts.** Alvin Anenberg (H) and Sally Anenberg (W) created a joint revocable trust that apparently included much (if not all) of their assets, including all the stock of a closely held company (Company) that owned and operated gas stations. H died in 2008, and various assets passed to Marital Trusts for the benefit of W, including almost half the stock of the Company. The remainder beneficiaries of the Marital Trusts following W's death were H's two sons by a prior marriage. H's executor made the QTIP election under §2056(b)(7).

In October 2011, one of the sons, as trustee of the QTIP trusts, filed a petition with a California state court to terminate the QTIP trusts and distribute all trust assets to W. "[A]ll beneficiaries (current and contingent)" consented to the court action. In March 2012, the court approved the termination and distribution to W of all the trusts' assets to W. At that time, the trusts' assets were worth $25.45 million and W's income interest was worth $2,599,463 (or 10,214% of the trust value, suggesting that W was 81 years of age at that time because the value of a life income interest in a trust for an 81 year-old person in March 2012, when the §7520 rate was 1.40%, was 10.214%).

In August 2012 (five months after the termination and distribution of the QTIP trusts' assets to W), W made a gift of about 6.4% of the shares of the Company she received from the QTIP trusts to trusts for the sons. In September 2012 (six months after the termination), W sold virtually all her remaining shares in the Company (including the roughly 50% that she had owned directly prior to H's death) to trusts for H's sons and grandchildren. Her sale proceeds were nine-year secured and partially guaranteed promissory notes with interest at the applicable federal rate (0.84%).

W timely filed a gift tax return for 2012, reporting the August 2012 gifts to trusts for the sons, and reporting the September 2012 sales as non-gift transactions.

The IRS reviewed the gift tax return, but W died in 2016 before the examination was completed. On December 1, 2020 (more than seven years after the gift tax return was filed), the IRS issued a Notice of Deficiency against W's estate determining that W was liable for more than $9 million gift tax "as a result of the termination of the Marital Trusts and the subsequent sales of the [Company] shares" (under §2519) with an accuracy related penalty of over $1.8 million. In the Tax Court proceeding, the IRS's second amended answer alleged for the first time an alternative argument that the termination of the QTIP trusts by itself was a disposition of W's qualifying income interest for life, triggering gift tax liability as a result of the deemed transfer of the remainder interest under §2519.

W's estate filed motions for partial summary judgment addressing each of the IRS's two arguments and asking the court to determine "that (i) the termination of the Marital Trusts and the distribution of the assets of the Marital Trusts to Sally did not result in a deemed gift under [section] 2519; [and that] (ii) Sally's sale of the [Company] shares received from the Marital Trusts in exchange for promissory notes did not result in a deemed gift under [section 2519]." (court's quotation of the motion). The IRS filed motions for partial summary judgment seeking the opposite results.

c. **Holdings That No Gift Tax Results From Alleged Section 2519 Deemed Transfers.**

(3) **Termination and Distribution to W of QTIP Trusts Assets**. "Assuming there was a transfer of property under I.R.C. § 2519 when the marital trusts were terminated, [W's estate] is not liable for gift tax under I.R.C. §2501 because W received back the interests in property that she was

treated as holding and transferring under I.R.C. §§ 2056(b)(7)(A) and 2519 and made no gratuitous transfer, as required by I.R.C. §2501."

(4) **Sale of Company Shares**. "[W's estate] is not liable for gift tax on the sale of [Company] shares for promissory notes because after the termination of the marital trusts [W's] qualifying income interest for life in QTIP terminated and I.R.C. § 2519 did not apply to the sale."

d. **Court Analysis of Section 2519 Issues.**

(3) **QTIP Regime.** The policy behind the marital deduction is to allow property to pass untaxed to a spouse, but to apply a transfer tax when property passes from the spouse (either at the spouse's death or by a gift from the spouse). The terminable interest rule is designed to deny a marital deduction in situations when the estate tax would not apply at the spouse's subsequent death.

The QTIP regime is an exception to the terminable interest rule allowing a marital deduction even though the surviving spouse only receives an income interest for life and has no control over the ultimate disposition of the property if the executor makes an election to opt into the QTIP regime so that estate or gift tax will apply when the property passes from the QTIP trust to beneficiaries designated by the first spouse to die. The QTIP rules "create a legal fiction under which the surviving spouse is treated as receiving all of the QTIP, when in reality the surviving spouse acquired only a lifetime income interest in that property." Opinion at 4. The court reiterates that that this "QTIP regime" in effect "creates a legal fiction under which the surviving spouse is treated as receiving all of the QTIP passing from the deceased spouse, when in reality the surviving spouse has acquired only a lifetime income interest in that property." Opinion at 10. The court quotes from Morgens v. Commissioner, 678 F.3d 769 (9th Cir. 2012), *aff'g* 133 T.C. 402 (2009):

> The underlying premise of the QTIP regime is that the surviving spouse is deemed to receive and then give the entire QTIP property rather than just the income interest. The purpose of the QTIP regime is to treat the two spouses as a single economic unit with respect to the QTIP property while still allowing the first-to-die spouse to control the eventual disposition of the property.

678 F.3d at 771.

The court observes that "[o]ther Code provisions continue the fiction that the surviving spouse owns the QTIP outright to ensure that if not consumed by the surviving spouse during her lifetime, the QTIP ultimately is subject to either the estate or gift tax." Opinion at 10.

Observation: An interesting article emphasizes the "tax fiction" created by the QTIP regime that in effect treats the spouse as owning the trust assets for transfer tax purposes, as referenced in *Anenberg*. Irwin, *Removing the Scaffolding: The QTIP Provisions and the Ownership Fiction*, 84 NEB. L. REV. 571 (2005).

(4) **Section 2519.** Section 2519 addresses the manner in which a transfer tax is applied to QTIP assets when there is a disposition during life rather than at death. In relevant part, §2519 provides as follows:

> Sec. 2519(a). General Rule.—For purposes of this chapter [imposing the gift tax] and chapter 11 [imposing the estate tax], any disposition of all or part of a qualifying income interest for life in any [QTIP] shall be treated as a transfer of all interests in such [QTIP] other than the qualifying income interest.

Accordingly, for gift and estate tax purposes, §2519 treats any disposition of the spouse's income interest as if the surviving spouse transferred 100% of the remainder interests in the QTIP.

The court emphasizes, however, that §2519 merely results in a deemed "transfer" of the assets, but a gift does not occur that is subject to gift taxation if property is transferred in exchange for full and adequate consideration in money or money's worth. Reg. §25.2511-1(g)(1).

(5) **IRS Position.** The IRS contended that W disposed of her qualifying income interest for life, thus triggering a deemed transfer of the remainder interest under §2519 at one of two times: (i) when W agreed to the termination of the QTIP trusts and accepted complete ownership of the QTIP

trusts, or (ii) when W, having accepted the QTIP assets, sold them in exchange for promissory notes.

Furthermore, the IRS contended that this triggering of §2519 treats W as transferring the full value of the QTIP assets less only the value of her qualifying income interest, and the full value of the QTIP remainder interest is treated as a gift.

(6) **Taxpayer Position.** W's estate argued (i) the 2012 transactions are not a disposition of a qualifying income interest but merely a conversion into an equivalent interest in other property (thus, §2519 does not apply), and in the alternative (ii) even if there was a disposition, no gift resulted because W received full and adequate consideration for the property she was deemed to transfer.

(7) **Court Analysis of the Parties' Positions Regarding Termination of QTIP Trusts and W's Acceptance of QTIP Assets.** The court does not decide if the termination of the Marital Trusts, followed by W's acceptance of the QTIP assets was a "disposition" with the meaning of §2519(a). The court said it did not need to resolve that question because it reasoned that even if there is a deemed transfer of the remainder interest under §2519, no gift resulted that is subject to gift taxation. Section 2519 may treat certain events as a deemed "transfer" of the remainder interest, but gift tax is imposed under § §2501 only "on the *transfer* of property *by gift* during [the] calendar year." Opinion at 14 (emphasis in original). Any deemed transfer of the remainder interest in the Company shares owned by the QTIP trusts that may have occurred under §2519 did not result in a gift because W ended up with all those shares unencumbered.

> … [W's] deemed transfer of the remainder interest in the [Company] shares held in trust … resulted in her actual receipt of all the [Company] shares unencumbered …. At the end of the day, she gave away nothing of value as a result of the deemed transfer. Accordingly, the termination of the Marital Trusts did not result in any "gratuitous transfers" by [W], deemed or otherwise. [Citation omitted] Because there was no gratuitous transfer, she made no gift.
>
> …
>
> Before the termination of the Marital Trusts, [W] held a qualifying income interest for life in the QTIP. She was deemed for estate and gift tax purposes to hold the remainder interests as well. But these interests, even when considered together, did not equate to unencumbered ownership. She was not free to do what she wished with the QTIP, which was held in the trusts. After the Superior Court order, [W]received the QTIP free of any trust restrictions. In these circumstances, to the extent section 2519 viewed [W] as transferring away the interests in property that the QTIP regime treated her as holding in the first place, it is hard to understand why [W] would not have received full and adequate consideration in return when she was also at the receiving end of the transfer of the property unencumbered. Before the Marital Trusts terminated, she actually held an income interest in the Marital Trusts' property valued at approximately $2.6 million, but was deemed to hold the entirety of the Marital Trusts' property valued at approximately $25.5 million. Immediately after the Marital Trusts terminated and (we assume) [W] was deemed to transfer the residual value of the Marital Trusts' property (approximately $22.9 million), she actually held assets valued at approximately $25.5 million. [W] could thus be viewed as fully compensated for whatever interest she was deemed to transfer.

Opinion at 15, 17-18

Considering all the facts of the case bolsters that conclusion: (i) no value passed to any else; and (ii) any purported gift would have been an incomplete gift because the termination was conditioned on W receiving all the trust assets, so she could control their further disposition, Reg. §25.2511-2(b).

(8) **Court Analysis of Parties' Position Regarding Subsequent Sale of Assets Received from QTIP Trusts.** The court cited two reasons that W's subsequent sale of Company shares she received on termination of the QTIP trusts did not trigger the application of §2519.

First, if the termination of the QTIP trusts was a disposition of W's qualifying income interest, that would have triggered §2519, and it would no longer apply to a subsequent transfer. "[H]er future transactions in the [Company] shares would be covered by the ordinary estate and gift tax rules rather than the QTIP regime."

Second, if the termination of the QTIP trusts was not a disposition triggering §2519, the QTIP trusts no longer existed at the time of the sale, so a qualifying income interest for life no longer existed, thus "eliminating the mechanism needed to trigger section 2519 in the future." Opinion at 19. (Footnote 21 states that the gift of shares in August 2012 did not trigger §2519 for the same reason.)

(9) **Responses to IRS's Arguments** The court responded directly to various IRS arguments made to support its position.

(a) **Consideration of the QTIP Regime.** The court rejected the IRS's position that §2519 itself "imposes gift tax," because §2519 merely results in a deemed "transfer," but §2501 imposes gift tax only on transfers "by gift." Congress used the phrase "transfer by gift" in other Code sections that directly resulted in gift taxation. *E.g.*, §2056A(b)(13) (treating lifetime distributions from a qualified domestic trust "as a transfer by gift").

This result makes sense under the QTIP regime concepts, to permit deferral of transfer taxation until the death of or gift by the surviving spouse.

> Where, as here, a surviving spouse receives the QTIP with respect to which she is deemed to transfer remainder interests, the value of the marital assets is preserved in her estate and will be taxed upon her death, assuming she does not consume the property or transfer it by gift at a later date. This is the same result that obtains when the marital deduction applies without regard to the QTIP regime.

The IRS cited various cases (Morgens, Novotny, and Kite), rulings (Rev. Rul. 98-8), and examples from regulations (Reg. §25.2519-1(a), (f), (g) (examples 1 and 2)) to support its position that gift tax should be imposed whenever a surviving spouse disposes of her qualifying income interest in QTIP. However, in those various sources, "the surviving spouse either disposed of the entire qualifying income interest by gift (i.e. for no consideration whatsoever) or else received consideration for the value of the income interest only." The key policy conclusion from those sources is that a gift tax would be imposed if "the value of the remainder interest in QTIP would have passed out of the surviving spouse's hands (and thus out of the marital unit) without ever being subject to estate or gift tax, contrary to the policy underlying the martial deduction and QTIP rules." Opinion at 21. But in this case, W's "receipt of the QTIP (and later the promissory notes) preserves the value of the marital assets in her hands for future gift or estate taxation." Opinion at 22. Indeed, the termination of the QTIP trust and distribution of its assets to the spouse is somewhat analogous to the appointment of assets to the spouse under a power of appointment, which Reg. §25.2519-1(e) specifically says is not a disposition that triggers §2519.

(b) **Regulation §25.2519-1(a).** The IRS cited Reg. §25,2519-1(a) to support its view that a disposition of any part of the qualifying income interest in a QTIP trust results in a deemed gift of the remainder interest. The second and third sentences of that regulation are as follows:

> For example, if the donee spouse makes a disposition of part of a qualifying income interest for life in trust corpus, the spouse is treated under section 2519 as making a transfer subject to chapters 11 and 12 of the entire trust other than the qualifying income interest for life. Therefore, the donee spouse is **treated as making a gift** under section 2519 of the entire trust less the qualifying income interest, and is treated for purposes of section 2036 as having transferred the entire trust corpus, including that portion of the trust corpus from which the retained income interest is payable.

Reg. §25.2519-1(a) (emphasis added).

While the third sentence says the spouse is treated as making a "gift" of the remainder interest, it does not say §2519 deemed transfers are always treated as gifts. The third sentence merely

> completes the example posited by the second sentence, in which the donee spouse has disposed of part of a qualifying income interest for life, presumably for no consideration or for consideration matching the value of the disposed-of partial interest. (That is why the third sentence refers to the "trust corpus" rather than "property" and the donee spouse's "retained income interest.")

Opinion at 24. The third sentence does not state a general rule for all §2519 purposes; the general rule is in the first sentence, which provides simply that "the donee spouse is treated … as *transferring* interests in property other than the qualifying income interest." Reg. §25.2519-1(a) (emphasis added).

(c) ***Estate of Kite.*** IRS attacks under §2519 on QTIP trust planning have intensified following the Tax Court's opinion in *Estate of Kite v. Commissioner*, T.C. Memo. 2013-43, and the IRS "makes much of" *Kite* in this case. *Kite* involved rather complicated facts, but in very simple terms, in a three-day series of planned transactions, the wife-beneficiary of QTIP trusts appointed her children as trustees, they terminated the trusts and distributed all trust assets to the wife, and the wife sold the assets to her children for a deferred private annuity (payment would not begin for 10 years and the wife died before receiving any payments). The court determined that the value of deferred annuity was full and adequate consideration for sale of the QTIP trust assets. The *Anenberg* opinion summarized *Kite* as follows:

> … this Court (at the Commissioner's urging) applied the substance over form doctrine to treat the transactions as one integrated transaction … [a]nd, in doing so, the Court concluded that the termination of the trust and subsequent sale of property was a disposition for purposes of section 2519(a).

Anenberg distinguished Kite on two grounds. (1) *Kite* applied the substance over form doctrine, and (2) because of the sale of QTIP assets for the deferred private annuity in *Kite*, it "involved an apparent attempt to prevent estate or gift tax from ever being imposed on the residual value of the QTIP." Neither of those applied in *Anenberg*. (*Kite* is discussed further in Item 27.e(5) below.)

(d) **No Consideration.** The IRS reasoned that the value of the Company shares were already included in W's taxable estate before the termination of the QTIP trusts, so the receipt of the Company shares could not have constituted adequate and full consideration "because she was already deemed to own them." The court viewed this a "wanting to have your cake and eat it too" argument by the IRS.

Under the QTIP regime, the value of the Company shares were included in W's estate before the QTIP trusts were terminated, and the court acknowledged that "section 2519(a) deemed [W} as giving up the remainder interests that she previously was deemed to have received from [H]. This in turn resulted in a (temporary as we will momentarily see) diminution of her estate." But that was only half the story.

> But the transaction did not stop there, and our analysis is not yet finished. The Superior Court ordered that all of the property held by the Marital Trusts be distributed to [W]…. The receipt of those shares "replenished" or "augmented" her (temporarily) diminished estate. In analyzing the tax consequences of the deemed transfer section 2519 contemplates, we cannot ignore that, as part of the same transaction, [W] in fact wound up with the unencumbered [Company] shares. We therefore decline the Commissioner's invitation to decide the case by taking into account only half of the relevant transaction.

Opinion at 26-27.

e. **Observations.**

(3) **Major Blow to IRS Attacks Under §2519.** Ever since the Tax Court's decision in *Kite v. Commissioner* over ten years ago, the IRS has increasingly been making §2519 attacks on planning involving existing QTIP trusts. The holdings and reasoning in the unanimous reviewed Tax Court opinion in *Anenberg*, delivered merely three months after the hearing on the motions for partial summary judgment, are a major blow to §2519 arguments the IRS has been making. If all the QTIP trust assets are distributed to the spouse-beneficiary, who later engages in transfer planning transactions, §2519 will not result in a deemed gift of the remainder interest subject to gift tax (at least if the termination/distribution/ transfer transactions are not part of an integrated plan under the substance over form doctrine – more about that in Item 27.e(3) below). The court's focus on the "QTIP regime," the tax fiction treating the spouse as owning the QTIP trust assets, and the key policy of deferring transfer taxation until the surviving spouse's subsequent

death (or gifts) but avoiding results that result in double taxation may be the guidepost for future decisions.

(4) **Commutations.** Commutation transactions, in which a QTIP trust is terminated by paying the beneficiaries the actuarial values of their respective interests, will continue to be subject to §2519 attacks. If the spouse-beneficiary is merely paid the actuarial value of his or her qualifying income interest for life, the reasoning in *Anenberg* specifically indicates that §2519 generally will apply, and the spouse will be treated as making a gift of the value of the remainder interest.

Anenberg reasons that because the spouse received *all* the QTIP trust assets, the spouse did not make a gift. To the extent the spouse does not receive all the QTIP assets, the difference would be a gift (either of a portion of the income interest or, more likely, of the remainder interest under §2519).

Footnote 17 in *Anenberg* specifically says that Section 2519 would apply and a taxable gift of the remainder interest would result in the classic commutation situation in which the spouse receives just the actuarial value of her income interest.

> The result would be different if [W] had received only the value of her qualifying income interest for life when the Marital Trusts terminated. In such a case, [W] would have been left with assets valued at approximately $2.6 million. The gratuitous transfer under section 2519 would be plain (although deemed) and would total approximately $22.9 million ($25.5 million of assets deemed held before the termination less her $2.6 income interest).

An extension of *Anenberg* is what would happen if the spouse received more than just the value of the qualifying income interest for life, but less than the full trust value. The reasoning in *Anenberg* suggests that the spouse makes a gift only to the extent that a "gratuitous transfer" is made. For example, assume a $100 QTIP trust is terminated and the spouse receives $40 even though the value of her income interest is only $20. If that is treated as a disposition of any portion of the income interest that triggers §2519, is the spouse treated as making a gift of the full value minus the value of the income interest ($100 - $20 = $80)? That would not make sense under the *Anenberg* reasoning, because the spouse was deemed to own $100 under the "legal fiction" of the QTIP regime and ends up owning $40 after the transaction. How does a gratuitous transfer occur of more than $60 ($100 owned before the transaction - $40 owned after)? The court's emphasis on the "gratuitous transfer" requirement suggests that a gift tax would not be imposed on the full value of the remainder interest.

Observe, that conclusion appears to be a repudiation of *Kite II*, which refused to allow any offset in the determining amount of gift resulting from a §2519 transfer for amounts received by the spouse in a transfer that triggers §2519. See Item 27.e(5)(b) below.

(5) **Step Transaction Doctrine.** The court's reasoning to distinguish *Kite* from this case is in part that *Kite* involved a substance over form argument which the IRS did not allege in this case. (In *Kite*, the termination of the QTIP trusts, the distributions of all assets to the surviving wife, and the sale by the wife for the deferred private annuity all occurred within a *three-day* span, whereas the gifts and sales of the QTIP trust assets in *Anenberg* occurred five months and six months, respectively, after the trust termination.)

Even if trust termination and a *sale* of the assets received from the trust are treated as integrated transactions, the spouse may not be treated as making a gift of the remainder interest under §2519 under the reasoning of *Anenberg*. The court reasoned that the deemed transfer of the remainder interest when §2519 is triggered results in a gift for gift tax purposes under §2501 only to the extent it is a "gratuitous transfer." If the spouse ends up with promissory notes having a current value equal to the value of the QTIP trust assets, presumably no gratuitous transfer occurs.

On the other hand, if a QTIP trust termination and *gift* of assets are treated as an integrated transaction, a gratuitous transfer would occur and some taxable gift may result under §2519. However, the gift may result only as to the gifted assets, and not the full remainder value of the trust, because the spouse would still own the remaining QTIP trust assets that had been

distributed to her following the QTIP trust termination. Those assets will be subject to transfer tax when the spouse subsequently dies or makes a gift of the assets, and the underlying premise of the QTIP regime and purpose of assuring that the QTIP trust assets will eventually be subject to a transfer tax would be served without imposing gift tax on the entire remainder interest under §2519 at the time of a gift of some portion of the assets in connection with the trust termination. That goes to the issue of whether *Anenberg* repudiates *Kite II* (as discussed in Item 27.e(5)(b) below). Treating the full remainder interest value as a taxable gift currently and subjecting the remaining assets to a transfer tax at death or up a later gift would result in double taxation of that value. The court's summary in *Anenberg* suggests that double taxation would not be appropriate.

> To summarize, in each of the Commissioner's cited sources, imposing the estate or gift tax resulted in *one-time taxation* of the value of the remainder interests in QTIP at the time that value left (or was deemed to leave) the surviving spouse's hands.

Opinion at 28 (emphasis added).

(6) **Gift by Remainder Beneficiaries Who Consent to All QTIP Assets Being Distributed to Spouse-Beneficiary; CCA 202128008; *McDougall v. Commissioner*.** A significant risk exists that the remainder beneficiaries may be treated as making a taxable gift to the spouse by consenting to the spouse receiving all the trust assets rather than just the actuarial value of her lifetime income interest. The IRS took the position in CCA 202128008 that trust remaindermen made a gift when they consented to the surviving husband receiving all the QTIP trust assets in a nonjudicial settlement agreement terminating the QTIP trust. For a detailed discussion (and strong criticism) of CCA 202118008, see Item 8.h of Estate Planning Current Developments (March 16, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** The cases connected with that CCA are addressed in *McDougall v. Commissioner*, 163 T.C. No. 5 (Sept. 17, 2024), discussed in Item 28 below.

(7) **Impact of *Kite v. Commissioner*.**

(a) ***Kite v. Commissioner* Brief Summary.** Mrs. Kite ("Wife") created a QTIP trust for Mr. Kite ("Husband") who died a week later. (Presumably, that inter vivos QTIP trust was created to obtain a basis adjustment at Husband's death, despite the limitations imposed by §1014(e).) Under the terms of the trust the assets remained in the QTIP trust for Wife's benefit, and Husband's estate made the QTIP election to qualify for the estate tax marital deduction.

Subsequently, the assets of the QTIP trust as well as another QTIP trust and a general power of appointment marital trust (collectively the "Marital Trusts") were invested in a limited partnership. Eventually the trusts' interest in a restructured partnership was sold to the Wife's children (and trusts for them) for notes and the notes were contributed a general partnership. In a three-day series of planned transactions, Wife replaced trustees of the Marital Trusts with her children as trustees, the children as trustees terminated the Marital Trusts (effective three months earlier) and distributed all of the trust assets (i.e., the interest in the general partnership) to Wife's revocable trust, the children contributed additional assets to the general partnership, and Wife (almost age 75) sold her partnership interests to her children for a deferred private annuity (annuity payments would not begin for 10 years). Wife died three years later before receiving any annuity payments.

(The children's authority as trustees to terminate the Marital Trusts and distribute all the assets to Wife is unclear. The opinion describes the principal distribution standards for the QTIP trust that Wife originally created but not for the other trusts. Principal from that QTIP trust could be distributed for "maintenance" and the trust could be terminated if the trust corpus was too small to justify management as a trust.)

The court's initial decision, *Kite v. Commissioner*, T.C. Memo. 2013-43 (decision by Judge Paris) (referred to as "*Kite I*"), held as follows.

> 1. The transfer of assets in return for the private annuities was for full consideration, was not illusory, and did not lack economic substance. Using the IRS actuarial tables was appropriate, even though the annuity payments would not begin for 10 years and Wife

had only a 12 1/2 year life expectancy, because Wife was not terminally ill at the time of the sale and she had at least a 50% chance of living more than one year. The sale was not illusory and was bona fide because the annuity agreement was enforceable and the parties demonstrated their intention to comply with the annuity agreement. "The annuity transaction was a bona fide sale for adequate and full consideration."

2. The transfer of assets from the QTIP Trusts to a limited partnership in return for limited partnership interests, the subsequent reorganization of the partnership as a Texas partnership (to save state income taxes), and the trusts' sale of the interests in the general partnership in return for 15-year secured notes did not constitute a disposition triggering §2519.

3. The liquidation of the QTIP trusts and the sale of the interests in the general partnership for the private annuities were part of an integrated transaction that was deemed to be a disposition of her qualifying income interest for life, that triggered §2519 and in turn caused a deemed transfer of the remainder interests in the QTIP trusts. The deemed transfer of the income interest was not a taxable gift under §2511 because Wife received full value. *Kite I* did not discuss what, if any, taxable gift resulted from the deemed transfer of the remainder interest. (The effect of the transfer of the income interest is determined under the general gift tax principles of §2511—the value of the portion of the income interest that is transferred less the consideration received for such transfer).

4. The transfer of assets from the general power of appointment marital trust to Wife was not a release of her general power of appointment causing a transfer under §2514 for gift tax purposes. The court only considered the termination of the marital trust and did not also consider the subsequent private annuity transaction as part of an integrated transaction in determining tax consequences of the transactions involving the general power of appointment marital trust.

Kite II is the court's Order and Decision regarding the Rule 155 computations of the gift tax as a result of the decision in *Kite I*. (Cause No. 6772-08, unpublished op. Oct. 25, 2013). The estate argued that no gift resulted from the deemed transfer of the remainder interest under §2519 because of the court's decision in *Kite I* that the Wife's sale of assets that she received from the QTIP trust in return for a deferred private annuity was a bona fide sale for adequate and full consideration.

Despite countervailing indications in the statute, regulations, and legislative history, the court in *Kite II* interpreted §2519 to mean that the full amount of the deemed transfer of the QTIP trust remainder interest is a gift, regardless of any consideration received by the surviving spouse. "[A] deemed transfer of a remainder interest under section 2519 cannot be made for adequate and full consideration or for any consideration."

The conclusion in *Kite II* that the amount of the *gift* resulting from the deemed *transfer* of the remainder interest was not offset by any payments made to the spouse was strongly criticized at the time it was published. *See Recent Developments*, 48th ANN. HECKERLING INST. ON EST. PL. (2014) (Ronald Aucutt ed.). Most planners and commentators had believed following *Kite I* that a zero gift would result from the deemed transfer of the remainder interest considering the court's determination that the wife received full value (an annuity) when she transferred the assets of the QTIP trust. *See e.g.,* Jeffrey Pennell, *Jeff Pennell on Estate of Kite: Will It Fly?* LEIMBERG EST. PL. EMAIL NEWSLETTER, Archive Message #2062 (February 11, 2013).

For a more detailed discussion of *Kite I* and *Kite II*, see Akers, *Kite v. Commissioner*, Rule 155 Order and Decisions (Cause No. 6772-08, unpublished opinion October 25, 2013) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights)**.

(b) ***Estate of Anenberg* Largely (If Not Totally) Repudiates *Kite II*.** *Anenberg* goes a long way toward repudiating *Kite II* in many situations. *Anenberg* very clearly concludes that, at least in

situations in which the entire QTIP trust assets are distributed to the spouse in a judicial termination of the trust, if there is a disposition of any of the qualifying income interest for life that results in a deemed "transfer" of the remainder interest under §2519, no taxable gift results of the remainder interest if the surviving spouse receives all the trust assets. No "gratuitous gift" has occurred, so no taxable gift of a deemed transfer of the remainder occurs following the disposition.

Whether that same result would apply if the termination of the trust and distribution of assets to the spouse and a sale by the spouse of the trust assets are treated as an integrated transaction under the "substance over form" doctrine was not addressed in *Anenberg*, but the reasoning in *Anenberg* would suggest that assets owned by the spouse following the integrated transaction (i.e., the promissory notes representing the sale proceeds) should offset any deemed gift of the remainder interest.

A further wrinkle in *Kite* is that the transaction involved a sale for a deferred private annuity with a structure that was planned to avoid subjecting any of the QTIP trust assets to estate or gift taxation, which is what happened in *Kite* because the Wife died before any annuity payments began and her annuity interest therefore terminated. Reducing the estate tax on the QTIP assets to zero was a byproduct of using a deferred private annuity sale transaction, but whether court after *Anenberg* would reach a differing result under §2519 on those facts cannot be known until a court rules directly on that situation.

(8) **Income Tax Consequences.** *Estate of Anenberg* does not discuss the income tax consequences of the judicial termination of the QTIP trusts (presumably, the IRS did not raise the issue). The IRS views the early termination of trusts as income tax events. The remainder beneficiaries in the Letter Rulings 201932001-201932010 were treated as having purchased the interests of the life beneficiary and the contingent remainder beneficiaries (and the life beneficiary had a zero basis in his interest under the uniform basis rules of §1001(e) so the total amount paid to the life beneficiary was capital gain). The remainder beneficiaries, as the deemed purchasers, do not pay tax on amounts **received** in the commutation (as the fictional purchasers, they are just receiving what is left in the trust after they have bought out everyone else), but they "realize gain or loss on the property exchanged." So, they recognize gain on the assets **paid out** to others less the amount of their uniform basis attributable to those assets. Massive income taxation can result, which could be totally avoided by not terminating the trust early. For a detailed discussion of the 2019 letter rulings and the income tax effects of early terminations of trusts, see Item 16 of Estate Planning Current Developments and Hot Topics (December 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

What the effect would be when the full trust value is paid to the income beneficiary of a QTIP trust is not clear. At least for income tax purposes, the remainder beneficiary may be treated as making a gift to the income beneficiary of the value of the remainder interest, which amount therefore would not be taxable income under §102(a). *See Commissioner v. Duberstein*, 363 U.S. 278, 284-286 (1960) ("detached and disinterred generosity"). Perhaps any deemed purchase by the remainder beneficiary would be limited to the value of the income interest. Prior to the Tax Court's decision in *McDougall v. Commissioner*, 163 T.C. No. 5 (Sept. 17, 2024), discussed in Item 28 below, it is conceivable that the remainder interest might have been treated as a gift for income tax purposes (and therefore not taxable income to the income beneficiary under §102) but not a gift for transfer tax purposes (because for transfer tax purposes the spouse is treated as the owner of the full value of the QTIP assets under the legal fiction created in the QTIP regime); however, *McDougall* rejected that analysis for transfer tax purposes.

(9) **Planning Regarding Spouse's Interest in QTIP Trusts.** For a discussion of QTIP trust planning alternatives, see Item .28.e(4) below.

30. QTIP Trust Planning; Do Remainder Beneficiaries Make Gifts by Consenting to Spouse Receiving All QTIP Assets?, *McDougall v. Commissioner*, 163 T.C. No. 5 (September 17, 2024); CCA 202118008

a. **Brief Synopsis.** *McDougall* is a Tax Court case that involved planning for assets in a large (about $118 million) QTIP trust that had more than doubled since it was funded. The trust was created following a wife's death, requiring that all net income be distributed to the surviving husband (H) and allowing principal distributions to him in the trustee's discretion for his health, maintenance, and support. H held a testamentary power of appointment to appoint the assets to the deceased wife's descendants, and in default of exercise the remainder at H's death would pass equally to their children (or the descendants of a deceased child).

Five years after the trust was created, H, his two children ("Children") as remainder beneficiaries, and virtual representatives of the contingent remainder beneficiaries, entered into an agreement to have all the trust property distributed to H. On the same day, H transferred "substantially all" the trust assets to trusts for the Children and their descendants in return for secured promissory notes.

This case was addressed in CCA 202118008. The IRS concluded that (1) descendants made gifts to H of their remainder interest, (2) H made a gift of QTIP trust remainder interest under §2519, and (3) H used gift exclusion and would have notes from the sale included in his gross estate.

The Tax Court issued a reviewed opinion on September 17, 2024, deciding two issues raised in cross motions for summary judgment by the parties.

First, the court held that H did not make a gift of the remainder interest under §2519. Neither (1) the termination of the trust and distribution of all assets to H nor (2) the distribution of assets to H coupled with the sale of substantially all the assets to trusts in return for notes resulted in a gift under §2519. Relying on *Estate of Anenberg*, the court reasoned that it did not decide whether those events resulted in "disposition" of any part of H's qualified income interest that triggered §2519. Even assuming there was a disposition that triggered §2519, because H ended up with all the trust assets (or notes reflecting the value of the trust assets) he made no gratuitous transfer. (The *McDougall* majority opinion did not mention the alternative "incomplete gift" rationale discussed in *Estate of Anenberg*.)

Second, the court held that the Children made gifts to H by agreeing that all the trust assets could be distributed to H. *Estate of Anenberg* did not discuss whether the remainder beneficiaries made gifts by agreeing to have all assets distributed to the spouse, but the IRS did raise that issue in *McDougall*. The majority's reasoning to support its conclusion that the Children made gifts by agreeing that all assets could be distributed to H included the following.

- The "QTIP fiction" treating H as owning the property focuses on deferring, imposing, and collecting a single transfer tax, not on transactions that persons other than the spouse may take with respect to their own interests in the QTIP.
- There are no "reciprocal gifts" between H and the Children because H is not treated as making a gift to the Children under §2519; furthermore, they already owned the remainder interests and a deemed transfer of remainder interests to them under §2519 "added nothing to their bundle of sticks."
- H's existing interest in the QTIP does not negate a gift by the Children; he was deemed to hold rights to the QTIP assets for purposes of determining *his* transfer tax liability, not whether others made gifts to him of their interests in the trust.
- The economic positions of the parties changed as a result of the distribution of all assets to H.

The court will determine the value of the Children's gifts to H in a later proceeding. The court specifically observed that "under the terms of [the wife's] will, [H] could have decided in his own will to reduce one of the children's shares significantly," and added in a footnote that "the import (if any) of these terms for the value of [the Children's] remainder rights remains to be decided."

A concurring opinion by Judge Halpern (who was the trial judge) reasoned that H did not dispose of a qualifying income interest in the property and therefore did not trigger §2519 (observing, among

other things, that a regulation analogously provides that a distribution of QTIP assets to the spouse under a power of appointment does not result in a disposition of the income interest by the spouse that triggers §2519 even if the spouse subsequently disposes of the appointed property.) Because H made no deemed transfer under §2519 to the Children, "their 'very real' transfers to him stand alone as taxable gifts."

The trial to determine the value of the children's gifts is set for June, 2025 (the case has been reassigned to Judge Halpern for the trial). All the gift issues have been resolved regarding the father, and a final order and decision for the father's case was entered December 26, 2025. (Taxpayers resided in Washington, so an appeal would be heard by the Ninth Circuit Court of Federal Appeals. Any notice of appeals must be filed with Tax Court clerk within 90 days of the entry of the final decision; that would be March 26, 2025.)

McDougall v. Commissioner, 163 T.C. No. 5 (Sept. 17, 2024) (majority opinion by J. Toro, concurring opinion by J. Halpern).

b. **Basic Facts.** Husband (H) was the beneficiary of a QTIP trust created by his deceased wife, who died in 2011. The trust was funded with about $54 million, and five years later it had more than doubled to about $118 million. The trust required that all net income would be distributed to H and allowed principal distributions to H in the trustee's discretion to provide for H's "health, maintenance and support in his accustomed manner of living." H held a testamentary power of appointment to appoint the assets to the decedent-wife's descendants. To the extent the power of appointment was not exercised, the remainder would be divided following H's death "into equal shares, one share for each of [the wife's] children who is then living and one share for each of [her] children who is then deceased with descendants then living."

In 2016, H, his two Children as remainder beneficiaries, and virtual representatives of the contingent remainder beneficiaries, entered into a nonjudicial agreement to have all the trust property distributed to H. On the same day, H transferred "substantially all" the trust assets to trusts for the Children and their descendants as a sale in return for secured promissory notes.

Notices of Deficiency asserted that H made a gift of the remainder interest under §2519 equal to about $106.8 million and the Children made gifts in an equal amount back to H. H's gift tax deficiency was about $47.7 million and the Children's gift tax deficiency was about $43.4 million, resulting in total gift tax deficiencies of over $90 million. And H was left owning promissory notes equal to the value of the QTIP assets that would be subject to transfer tax in the future.

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

The three gift tax cases involving H and each of the two Children were consolidated for trial. *McDougall v. Commissioner*, Docket Nos. 2458-22, 2459-22, and 2460-22 (Petitions filed February 18, 2022, Judge Halpern). (The taxpayers are represented by John Porter, Keri Brown, and Tyler Murray.) For a detailed description of the IRS's and taxpayers' arguments in the case, see Item 30 of Akers, Aucutt, and Nipp, *Estate Planning Current Development and Hot Topics* (December 31, 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

c. **Majority Opinion Analysis.**

(3) **No Gift of the Remainder Interest by H Under Section 2519; Analysis Relying on *Estate of Anenberg*.** The majority opinion summarized "lessons from *Estate of Anenberg*." *Estate of Anenberg v. Commissioner*, 162 T.C. No. 9 (May 20, 2024), addressed similar facts. It reasoned that the court did not need to decide if the spouse-beneficiary made a disposition of any part of

the qualifying income interest that triggered a deemed transfer of the remainder interest under §2519. Even if it did, that only resulted in a deemed "transfer" of the remainder interest, but no gift resulted because the surviving spouse ended up actually owning all the assets unencumbered. "At the end of the day, she gave away nothing of value as a result of the deemed transfer." *Estate of Anenberg v. Commissioner*, slip op. at 15.

The IRS in McDougall maintained that H made a deemed gift of the remainder interest under §2519(a) arguments: (1) as a result of "the implementation of the Nonjudicial Agreement"; or (2) by "the implementation of the Nonjudicial Agreement coupled with the subsequent sale of the trust property for promissory notes." The court rejected the IRS's position. Footnote 5 of the majority opinion in McDougall stated (similar to Estate of Anenberg) that the court did not decide whether a disposition of H's qualifying income interest occurred that triggered §2519. Even if it did, no gift of the remainder interest resulted "for the reasons we set out in Estate of Anenberg." McDougall v. Commissioner, slip op. at 11.

(4) **Children Made Gifts.** The majority rejected various arguments by the taxpayers to support that the Children made no taxable gifts by agreeing that H could receive all the trust assets.

(a) **Scope of the QTIP Fiction.** Taxpayers argued that the QTIP fiction (treating the spouse as owning the QTIP) means "the children simply had nothing that they could give away." *Id.* at 13. The court observed that the QTIP fiction does not apply for all purposes (citing *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999)), but more importantly reasoned that the QTIP provisions focus on deferring transfer tax until the death of or gift by the surviving spouse. They focus on the transfer of marital assets outside the marital unit but "say nothing about, and do not apply to, transactions that transferees outside the marital unit, such as [the Children], may undertake with respect to their own interests in QTIP." *McDougall v. Commissioner*, slip op. at 13.

(b) **Reciprocal Gifts.** The taxpayers argued that H and the Children made reciprocal gifts that offset each other. However, the court's determination that H did not make a gift under §2519 meant that no reciprocal gifts could have occurred. Furthermore, the Children could not receive anything of value as a result of the nonjudicial agreement because "they already had the remainder rights" and a deemed transfer under §2519 "added nothing to their bundle of sticks." *Id.* at 14.

(c) **H's Existing Interest in the QTIP.** Taxpayers argued that while the Children may have interests under state law as trust remainder beneficiaries, H is treated as the owner of the assets for tax purposes under the fiction of the QTIP regime. How can one make a gift of an asset to a donee who already owns the asset for tax purposes? The court disagreed. "Any rights [H] may have been deemed to hold because of the QTIP fiction do not negate the very real interests [the Children] held …." *Id.* at 15. If the Children had transferred their rights to a third party, the transfers would clearly be a gift; that H was the recipient does not change this conclusion.

(d) **Economic Position of the Parties.** The taxpayers maintained that the economic positions of the parties were unchanged, but the court explained why the economic positions of the parties clearly changed. H did not own the assets outright before the trust termination but afterward he did. The Children owned remainder interests before the termination and afterward they did not. *Id.*

(5) **Value of Children's Gifts.** The court will determine the value of the Children's gifts to H in a later proceeding. *Id.* at 12, n.7. The trustee could make discretionary principal distributions to H, and H held a testamentary power of appointment to appoint trust assets to the wife's descendants. The court specifically observed that "under the terms of [the wife's] will, [H] could have decided in his own will to reduce one of the children's shares significantly," *id.* at 15-16, and added in a footnote that "[t]he import (if any) of these terms for the value of [the Children's] remainder rights remains to be decided." *Id.* at 16, n.10. (Because the valuation issue is still pending, there is no final judgment, and periods to appeal the case are not running.)

d. **Concurring Opinion Analysis.** The fourteen-page majority opinion (ten pages of which discussed the legal issues) is followed by a thirteen-page concurring opinion by Judge Halpern (who is the trial judge) describing how he would analyze the case differently than the other thirteen judges to arrive at the conclusion that the Children made gifts by joining in the nonjudicial agreement terminating the trust and leaving all the trust assets to H.

(3) **Adequate Consideration vs. Incomplete Transfer Rationale.** *Estate of Anenberg* discussed two alternate approaches for its conclusion that the surviving spouse did not make a gift of the remainder interest under §2519: (1) the spouse received adequate consideration offsetting the value of a deemed transfer of the remainder interest; or (2) the spouse's deemed transfer under §2519 resulted in an incomplete gift. The *Estate of Anenberg* opinion relied primarily on the adequate consideration rationale.

(4) **That Approach Yields Incongruous Results in *McDougall*.** The issue in *McDougall* is whether the Children made gifts. The concurring opinion interprets the majority analysis as treating H as receiving adequate consideration for his deemed transfer of the remainder interest "but, from [the Children's] perspective, their transfers were wholly gratuitous and thus taxable gifts." *McDougall v. Commissioner*, slip op. at 21. Judge Halpern questions "whether the bounds of the QTIP fiction are so clearly delineated as to justify that differential treatment." *Id.*

(5) **Scope of QTIP Fiction.** Section 2519(a) does not "expressly provide that the surviving spouse can be treated as having received consideration for a deemed transfer of interests" [the issue explored in the controversial *Kite II* order], and Judge Halpern asks how far the QTIP fiction can be extended beyond the express terms of the relevant statutory provisions. *Id.* at 22. After striking down what Judge Halpern perceives as several red herrings (reciprocal gift arguments and whether the *U.S. v. Grace* doctrine applies to perceived reciprocal gifts), the concurring opinion reasons that the majority justifies treating H but not the Children as receiving adequate consideration, in its "selective recognition of offsetting transfers by perceived limits on the scope of the QTIP fiction." *Id.* at 23. But Judge Halpern observes philosophically: "Transfers that, from [H's] perspective, were consideration paid *to him* should be viewed, from [the Children's] perspective, as consideration paid *by them*." *Id.* at 24 (emphasis in original). Judge Halpern believes that philosophical dichotomy could be avoided with an alternate analysis.

(6) **Alternative Analysis Using Incomplete Gift Rationale**.

(a) **Following the Incomplete Gift Rationale.** If any deemed transfer was a wholly incomplete gift, "it cannot have provided adequate and full consideration to [the Children] for their transfers to him." *Id.* Judge Halpern believes the wholly incomplete gift analysis may "prove too much." *Id.* But it calls into question whether, because of the interests and control H had in and over the trust assets, "a disposition of [H's] qualifying income interest in the [trust] property occurred in the first instance." *Id.*

(b) **No Disposition Under §2519(a)**. That H relinquished his beneficial interest in the QTIP "trust" "is of no moment." *Id.* at 25. Section 2519(a)'s references to "any disposition of all or part of a qualifying income interest in property to which this section applies" is to the property for which a marital deduction was allowed–the property that funded the QTIP trust. The issue "is not whether [H] disposed of his interest in the *trust* but whether he disposed of his qualifying income interest in the *trust property*." *Id.* (emphasis added).

After the trust termination H may have relinquished his beneficial interest in the trust, but he "owned *all* the interests in the property." *Id.* (emphasis in original). While the termination of the trust may have terminated H's qualifying income interest in the property, he retained all interests he owned in the trust property before the termination (which included the right to all income) and also received additional rights (outright ownership). "Acceptance of additional rights to property that add to those previously owned cannot be viewed as a relinquishment of the previously owned rights." *Id.* at 26.

Accordingly, Judge Halpern concludes that the disposition of all the trust property to H "did not effect a disposition of his qualifying income interest in the trust property" under §2519(a).

That is consistent with the policy of the QTIP regime because the property (or sales proceeds from the sale of the property as pointed out in footnote 4 of the concurring opinion) would be included in H's gross estate under §2033.

On the other hand, a commutation of the trust with H receiving only the value of the income interest "would have effected a disposition of [H's] qualifying income interest in the trust assets" because he "would have relinquished any interest in the trust assets distributed to [the Children]." *Id.* at 27.

Judge Halpern points out the analogy the taxpayers had noted to Reg. §25.2519-1(e), stating that "[t]he exercise … of a power to appoint [QTIP] to the donee spouse is not treated as a disposition under section 2519, even though the donee spouse subsequently disposes of the appointed property." The regulation further supports that the distribution of all trust assets to H did not result in a disposition triggering §2519 because "the distribution of all trust property to [H] had the same effect as the exercise of a power to appoint the [trust] property to [H]." *Id.* at 28.

(7) **Conclusion**. If the distribution of all trust property to H pursuant to the nonjudicial agreement was not a deemed transfer under §2519(a) from H to the Children, "then, as the majority concludes, he made no taxable gifts to them, and their 'very real' transfers to him stand alone as taxable gifts." *Id.* at 29. Judge Halpern points out that, unlike the analysis in the majority opinion, this analysis "does not depend on treating a single exchange differently from the perspective of the transferors and the transferee …. Concluding that the implementation of the Nonjudicial Agreement did not effect a disposition of [H's] qualifying income interest provides a more straightforward justification for the conclusions that [H] did not make a taxable gift but [the Children] made taxable gifts to him." (The majority responded in footnote 11 at the end of the majority opinion that "the analytical path [the concurring opinion] offers is neither more straightforward nor sounder than the one we adopt.")

e. **Observations.**

(3) **Analysis Important for Growing Attacks by IRS on Transactions With QTIP Trusts**. Planning for surviving spouses who are beneficiaries of substantial QTIP trusts is complicated but very important because assets remaining in a QTIP trust at the surviving spouse's death will be included in the spouse's gross estate for estate tax purposes. The §2519 issue appears to be a focus of the IRS, and the IRS has been attacking transactions involving QTIP trusts under §2519 with growing frequency. John Porter, one of the attorneys representing the taxpayer in *Estate of Anenberg* and in *McDougall*, says he is aware of several of these types of cases currently in litigation. Various attorneys indicate they have pending examinations involving §2519.

Estate of Anenberg and *McDougall* make clear that those attacks under §2519 will be unsuccessful in situations where all QTIP assets are distributed to the spouse-beneficiary. The key to the §2519 analysis in both cases is that assets passing to the spouse-beneficiary can be applied to offset deemed transfers of the remainder interest under §2519, repudiating the result in *Kite II*. (*Kite I* and *Kite II* are discussed in Item 27.e(5) of Akers & Nipp, *Looking Ahead – Estate Planning in 2024, Current Development & Hot Topics* (October 2024) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.) *McDougall,* however, indicates that gift issues may arise for remainder beneficiaries when QTIP trusts are terminated early with the consent of the remainder beneficiaries.

(4) **Commutations**. That "offsetting transfer" analysis would not prevent a classic commutation of beneficial interests in a QTIP trust from resulting in a deemed gift under §2519. To the extent the spouse does not receive all the QTIP assets, the difference would be a gift (either of a portion of the income interest or, more likely, of the remainder interest under §2519). Footnote 17 *in Estate of Anenberg* and Judge Halpern's concurring opinion in *McDougall* specifically pointed out that §2519 could be triggered under a classic commutation of beneficial interests. *See also* Letter Ruling 202016002 (commutation of a spouse's qualifying income interest in a QTIP trust in return for the actuarial value of the income interest treated as a transfer under §2519 of all interests in

the trust other than the qualifying income interest; remainder interest was held by charitable trust and deemed transfer by the spouse to the charitable trust qualified for the gift tax charitable deduction). The spouse would be treated as disposing of a qualifying income interest if the spouse does not receive all the trust assets on the early termination of the trust because the spouse "would have relinquished any interest in the trust assets distributed to" other beneficiaries. *McDougall v. Commissioner*, slip op. at 28.

(5) **Step Transaction Analysis.** *Estate of Anenberg* did not address whether the combination of the distribution of all QTIP assets to the spouse followed by the sale of the assets would trigger §2519. That seemed to be the general approach of *Kite I* (finding that the combination of the distribution of all assets to the surviving wife followed by her sale of the assets for a deferred private annuity triggered §2519). The IRS did not make that step transaction argument in *Estate of Anenberg*, but it did in *McDougall*, and the court rejected the argument. Combining an early termination of QTIP assets entirely to the spouse with even an immediate sale of the assets by the spouse is safe from a step transaction attack under §2519 in the Tax Court because of *McDougall*.

(6) **QTIP Planning Considerations In Light of *Estate of Anenberg* and *McDougall***. Estate freezing strategies are helpful to minimize the growth in the QTIP assets that will ultimately be subject to transfer tax.

(a) **Estate Freezing by the QTIP Trust**. One alternative is for the trustee to enter the estate freezing transaction directly with the QTIP trust assets. This could be as simple as having the trust invest in fixed income portfolios and having other trusts for the family invest in more aggressive equity portfolios. The combined trust portfolios (presumably for the same beneficiaries) could represent an appropriately diversified portfolio. Fiduciary issues obviously should be considered. Beyond that, the QTIP trust might sell assets to other family trusts or entities that are not subject to the transfer tax in return for notes. If accomplished shortly after the first spouse's death, the basis adjustment under §1014 might mean that relatively little gain would be recognized on the sale.

(b) **Distributions to Spouse.** Another alternative is to take steps to get the QTIP trust assets into the hands of the spouse-beneficiary so that person can enter into freezing transactions (gifts or sales). Consider making principal distributions to the spouse in accordance with the distribution standards.

If large principal distributions to the spouse-beneficiary cannot be justified under the distribution standard in the trust agreement, do not assume the IRS will just acquiesce in improperly made distributions to the spouse.

i. **Gift by Beneficiaries Who Fail to Object.** The IRS may take the position that remainder beneficiaries make gifts to the spouse by not objecting and taking actions to prevent the improper distributions. *See* CCA 202352018 (trust beneficiaries made gift to grantor by consenting to modification action to add reimbursement power; result would have been the same if the beneficiaries had not explicitly consented if they had notice of the modification and a right to object but failed to exercise their right to object).

ii. **Improperly Distributed Asset Treated As Still in Trust.** The IRS may take the position that the improperly distributed assets should be treated as if they were still in the trust. *See Estate of Lillian Halpern v. Commissioner*, T.C. Memo. 1995-352 (distributions from general power of appointment marital trust to descendants; spouse consented but the distributions were not authorized; court recognized the distributions that were made when the spouse was competent but did not recognize distributions made after the spouse had become incompetent because a guardian could have set aside the distributions, so those distributions were included in the spouse's estate under §2041); *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278 (beneficiary-trustee made distribution to self, contrary to standards in trust, and sold those assets for private annuity; trust assets included in decedent's gross estate under §2036 and the distributed

assets were not excluded from the decedent's gross estate merely because of ascertainable standards in the trust); *Estate of Hartzell v. Commissioner*, T.C. Memo. 1994-576 (court rejected IRS argument that assets distributed from marital trust to decedent during her lifetime and given to family were includable in her gross estate because the distributions were improper transfers from the trust; Ohio court would have approved the transfers because distribution standard of "comfort, maintenance, support, and general well being" would include distributions to assist her desire to continue giving gifts to family members to ensure family control of family businesses); *Estate of Council v. Commissioner*, 65 T.C. 594 (1975) (IRS argued that trustee did not have the authority to distribute trust assets to spouse for gifting purposes; court stated that the issue was not whether a state court would have approved the distributions beforehand but whether a state court would rescind the distributions after made; conclusion that trustees acted within the bounds of reasonable judgment); *cf. United Food & Commercial Workers Unions v. Magruder Holdings, Inc.*, Case No. GJH-16-2903 (S.D. Md. March 27, 2019) (failure to comply with fiduciary constraints regarding trust distributions caused a trust to be treated as a grantor trust for non-tax purposes); *SEC v. Wyly,* 2014 WL 4792229 (S.D.N.Y. September 25, 2014) (SEC recoupment case; court reasoned that a failure to comply with fiduciary constraints regarding trust distributions caused a trust to be treated as a grantor trust for non-tax purposes).

(c) **Additional Transfers to Spouse.** If the goal is to get more assets to the spouse than can be justified under the distribution standards, trust modification actions may be considered to get assets to the spouse-beneficiary. This could be a traditional commutation (with the spouse receiving the actuarial value of his or her interest in the trust) or be a complete distribution of trust assets to the spouse in an early termination (as was done in *Estate of Anenberg* and *McDougall*). (Beware that early terminations of trusts can have disastrous income tax consequences, as discussed in Item 28.e(5) below.)

i. **Traditional Commutation.** A traditional commutation would not be covered by the rationale of the Tax Court in the *Estate of Anenberg* and *McDougall* cases and would result in the spouse being treated as making a gift of the full remainder interest in the trust under §2519. See Item 28.e(2) above.

ii. **Termination and Distribution of All Assets to Spouse.** If the spouse receives all the assets (by agreement with the remainder beneficiaries), the spouse should avoid making a gift under §2519, but the remainder beneficiaries may be treated as making a gift of their interests in the trust to the spouse. The amount of the gift by each remainder beneficiary may be reduced because of contingencies (possible principal distributions to the spouse or possible exercises of powers of appointment appointing assets away from the particular beneficiary).

iii. **Decanting.** Using decanting rather than judicial termination or nonjudicial settlement agreement to transfer assets to the spouse (perhaps by adopting a broad distribution standard) may avoid having explicit consent from remainder beneficiaries, but there are fiduciary concerns and the IRS took the position in CCA 202352018 that failing to object would result in a gift, the same as with consent. See Item 7 above. But at least that approach may avoid direct consent by the remainder beneficiaries.

iv. **Aggressive Transactions?** In the face of the growing attacks by the IRS under §2519 and *McDougall*, planners may view these types of transfers as aggressive transactions.

v. **Particular Significance in 2024-2025.** Planning with QTIP trusts to get assets to the spouse so the spouse can make gifts is especially significant in 2024-2025 when the spouse may be looking for ways to make gifts to utilize the large gift exclusion amount before it may be reduced in 2026 (although that now appears unlikely).

(d) **Drafting Issue: Power of Appointment to Appoint Assets to Spouse.** In drafting QTIP trusts to leave the flexibility of getting trust assets to the spouse-beneficiary, consider giving

a third party a power of appointment to appoint assets to the spouse. Reg. §25.2519-1(e) ("[t]he exercise … of a power to appoint [QTIP] to the donee spouse is not treated as a disposition under section 2519, even though the donee spouse subsequently disposes of the appointed property").

If an existing trust does not include such a power of appointment, consider if the trust could be decanted to a trust that would add such a power of appointment (if permitted under the state decanting statute). If such decanting is within the proper exercise of the trustee's discretion, the children should not be treated as making a gift because of the decanting.

If assets are moved into the hands of the spouse-beneficiary by the exercise of a power of appointment, that should avoid the possibility of the IRS arguing that the transaction should be treated as a gift from the remainder beneficiaries to the income beneficiary or as a purchase of the income beneficiary's interest by the remainder beneficiaries, resulting in a gain recognition transaction (discussed in Item 28.e(5) below).

(e) **Drafting Issues: Power of Appointment Over Remainder.** As in *McDougall*, giving the spouse (or someone) a power of appointment to appoint the remainder at the spouse's death provides an argument for minimizing the gift amount by any particular beneficiary resulting from the beneficiary's consent to an early termination of the QTIP trust.

(f) **Division Into Separate QTIP Trusts.** If the goal is to do freeze planning with only part of the QTIP trust assets, first divide the QTIP trust proportionately into separate trusts. Do the freeze planning with one of the trusts, leaving the other trust untouched to avoid §2519 and gift issues. Many PLRs have allowed taxpayers to sever QTIP trusts in anticipation of this type of planning. *E.g.*, Letter Ruling 202146001.

(g) **Resources.** Be forewarned that planning with large QTIP trusts is difficult. *See* Joy Miyasaki & Read Moore, *Estate Planning Strategies for QTIP Trusts: Do Good Things Come to Those Who Defer?*, AMERICAN COLLEGE OF TRUST & ESTATE COUNSEL 2023 ANNUAL MEETING (March 2023); Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12, ¶1202.3 (2010). For a discussion of other planning alternatives (including planning for distributions to the spouse, and the risks of unauthorized distributions, so the spouse can make estate planning gifts and transfers of those assets), see Item 9.h of Estate Planning Current Developments and Hot Topics 2022 (December 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. *See also* Richard S. Franklin, *Lifetime QTIPs—Why They Should Be Ubiquitous in Estate Planning*, 50th HECKERLING INST. ON EST. PL. ch. 16 (2016); Richard S. Franklin & George Karibjanian, *The Lifetime QTIP Trust – the Perfect (Best) Approach to Using Your Spouse's New Applicable Exclusion Amount and GST Exemption*, 44 BLOOMBERG TAX MGMT. ESTATES, GIFTS & TR. J. 1 (March 14, 2019).

(7) **Income Tax Consequences.** Apparently, the IRS did not take the position in either *Estate of Anenberg* or *McDougall* that the early termination of the QTIP trust resulted in an income taxable transaction between the income and remainder beneficiaries. The IRS views the early termination of trusts as income tax events. The remainder beneficiaries in Letter Rulings 201932001-201932010 were treated as having purchased the interests of the life beneficiary and the contingent remainder beneficiaries (and the life beneficiary had a zero basis in his interest under the uniform basis rules of §1001(e) so the total amount paid to the life beneficiary was capital gain). The remainder beneficiaries, as the deemed purchasers, do not pay tax on amounts **received** in the commutation (as the fictional purchasers, they are just receiving what is left in the trust after they have bought out everyone else), but they "realize gain or loss on the property exchanged." So, they recognize gain on the assets **paid out** to others less the amount of their uniform basis attributable to those assets. Massive income taxation can result, which could be totally avoided by not terminating the trust early. For a detailed discussion of the 2019 letter rulings and the income tax effects of early terminations of trusts, see Item 16 of Estate Planning Current Developments and Hot Topics (December 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

What the effect would be when the full trust value is paid to the income beneficiary of a QTIP trust is not clear. At least for income tax purposes, the remainder beneficiary may be treated as making a gift to the income beneficiary of the value of the remainder interest, which amount therefore would not be taxable income under §102(a). *See Commissioner v. Duberstein*, 363 U.S. 278, 284-286 (1960) ("detached and disinterested generosity"). Perhaps any deemed purchase by the remainder beneficiary would be limited to the value of the income interest. See Item 27.e(6) above.

(8) **Valuation Issue.** The valuation issue is very interesting. Any particular remainder beneficiary has significant contingencies on actually receiving trust assets. How will the court value those contingencies? Collectively, all the remainder beneficiaries in *McDougall* were assured of receiving the trust assets (other than assets that might have been distributed to H under the trust distribution standard) because H's power of appointment was to appoint the assets to the deceased wife's descendants, and they happened to be the remainder beneficiaries. But H could cut off any particular remainder beneficiary's interest. How would each such remainder beneficiary's interest be valued under that contingency? (The IRS dismissed the impact of H's power of appointment in CCA 202118008 and apparently is taking the position in *McDougall* that the early termination of the trust means the power of appointment no longer exists and is irrelevant to the valuation issue.)

Why did the IRS take the position that the gifts were made merely by the two children rather than allocating gifts among all of the descendants who were remainder beneficiaries?

Will the valuation issue will be settled (most valuation disputes end up being settled)? If so, we will never know how the court would have addressed the valuation issue. However, attorneys for the parties anticipate that the valuation issue will go to trial. The case has been reassigned to Judge Halpern for trial of the valuation issue, and a trial date has been set in June, 2025.

31. Estate Tax Value of Shares Included Proceeds of Corporate-Owned Life Insurance to Fund Buy-Sell Agreement, Not Offset by Redemption Obligation; Buy-Sell Agreement Did Not Meet §2703(b) Safe Harbor or Other Requirements to Fix Estate Tax Value, *Connelly v. United States,* 602 U.S. __ (2024) *aff'g* 131 AFTR 2d 2023-1902 (8th Cir. June 2, 2023), *aff'g* 128 AFTR 2d 2021-5955 (E.D. Mo. Sept. 2, 2021)

a. **Synopsis.** A buy-sell agreement for a corporation owned by two brothers gave the surviving brother the option to purchase the decedent's shares, or if not exercised, required the corporation to buy the decedent's shares. The pricing provision called for the parties to agree annually on the company value, and if an annual value had not been agreed on, the price would be determined by securing two or more appraisals (which would not consider control premiums or minority discounts). The company funded the agreement with life insurance policies on the two brothers' lives. The brothers never entered into any agreement about the company value, and on the death of the brother owning about 77% of the company, the estate and the company did not comply with the appraisal requirement in the agreement but agreed the company would pay the estate $3 million (using part of the $3.5 million of life insurance proceeds paid to the company) (as well as providing other benefits for the deceased brother's son).

The estate reported the shares at about $3 million, taking the position that the $3 million used to purchase the shares should not be included in determining the value of the corporation; under that approach, the corporation 's value was $3.86 million, and the decedent's 77% interest was worth $3 million. The IRS assessed an additional $890,000 of estate tax, maintaining the $3 million of life insurance proceeds should have been taken into consideration in determining the value. The estate paid the additional estate tax and sued for a refund.

The court considered whether the buy-sell agreement set a $3 million price that controlled for estate tax purposes, and if not, the only issue after stipulations was whether the $3 million of life insurance proceeds used to purchase the estate's shares should be considered in determining the value of the shares for estate tax purposes.

The district court and Eighth Circuit determined that the agreement did not set a price that was binding for estate tax purposes. In valuing the stock without regard to the agreement, both the district court and Eighth Circuit determined that the $3 million should be included in determining the value of the decedent's shares. Both courts disagreed with the Eleventh Circuit's rationale in *Estate of Blount v. Commissioner* (2005) that the contractual obligation of a company to purchase a decedent's shares offsets the life insurance proceeds on the decedent's life paid to the company.

The U.S. Supreme Court affirmed, reasoning (1) a redemption of shares at fair market value does not affect any shareholder's economic interest, (2) no willing buyer purchasing the decedent's shares would have treated the corporation's obligation to redeem the shares at fair market value as a factor that reduced the value of those shares, (3) treating the redemption obligation as a liability cannot be reconciled with the basic mechanics of a stock redemption, and (4) that this result makes succession planning more difficult is simply a consequence of how the parties structured the purchase obligation and other options existed that could have avoided the result of insurance proceeds increasing the value of the decedent's shares. *Connelly v. United States.*, 602 U.S. ___ (June 6, 2024) (Justice Thomas, unanimous), *aff'g* 70 F.4th 412, 131 AFTR 2d 2023-1902 (8th Cir. 2023), *aff'g* 128 AFTR 2d 2021-5955 (E.D. Mo. 2021).

b. **Basic Facts.** The basic facts were concisely summarized in the unofficial syllabus of the Supreme Court opinion:

> Michael and Thomas Connelly were the sole shareholders in Crown C Supply, a small building supply corporation. The brothers entered into an agreement to ensure that Crown would stay in the family if either brother died. Under that agreement, the surviving brother would have the option to purchase the deceased brother's shares. If he declined, Crown itself would be required to redeem (*i.e.*, purchase) the shares. To ensure that Crown would have enough money to redeem the shares if required, it obtained $3.5 million in life insurance on each brother. After Michael died, Thomas elected not to purchase Michael's shares, thus triggering Crown's obligation to do so. Michael's son and Thomas agreed that the value of Michael's shares was $3 million, and Crown paid the same amount to Michael's estate. As the executor of Michael's estate, Thomas then filed a federal tax return for the estate, which reported the value of Michael's shares as $3 million. The Internal Revenue Service (IRS) audited the return. During the audit, Thomas obtained a valuation from an outside accounting firm. That firm determined that Crown's fair market value at Michael's death was $3.86 million, an amount that excluded the $3 million in insurance proceeds used to redeem Michael's shares on the theory that their value was offset by the redemption obligation. Because Michael had held a 77.18% ownership interest in Crown, the analyst calculated the value of Michael's shares as approximately $3 million ($3.86 million x 0.7718). The IRS disagreed. It insisted that Crown's redemption obligation did not offset the life-insurance proceeds, and accordingly, assessed Crown's total value as $6.86 million ($3.86 million + $3 million).The IRS then calculated the value of Michael's shares as $5.3 million ($6.86 million x 0.7718). Based on this higher valuation, the IRS determined that the estate owed an additional $889,914 in taxes. The estate paid the deficiency and Thomas, acting as executor, sued the United States for a refund. The District Court granted summary judgment to the Government. The court held that, to accurately value Michael's shares, the $3 million in life-insurance proceeds must be counted in Crown's valuation. The Eighth Circuit affirmed.

c. **District Court and Eighth Circuit Analysis of Whether Buy-Sell Agreement Set $3 Million Value Binding For Estate Tax Purposes.** The district court determined that the buy-sell agreement did not fix the value of the shares for federal estate tax purposes. First, it did not satisfy the §2703(b) safe harbor; although the agreement met the bona fide business purpose test, it failed to meet the device test (because the purchase price did not include the life insurance proceeds in determining the company's value, the *process* of selecting the redemption price indicates the agreement was a testamentary device, and the agreement prohibited considering control premiums or minority discounts) and the comparability test (the estate "failed to provide any evidence of similar arrangements negotiated at arms' length"). Second, the agreement did not satisfy requirements recognized by various courts for buy-sell agreements to fix estate tax values: the agreement did not provide a fixed and determinable price; it was not binding at death (evidenced by the fact that its procedures were not followed); and it was a substitute for a testamentary disposition for less than full consideration.

The Eighth Circuit agreed, reasoning more succinctly that the agreement did not set the estate tax value of the decedent's stock because the agreement did not establish a "fixed and determinable price." (Even if the pricing mechanism in the agreement had been followed, the court expressed

reservations about whether those pricing mechanism would have been sufficient to establish a fixed and determinable price.)

For a more detailed discussion of the district court and Eight Circuit analysis of this issue, see Item 28.c-d of LOOKING AHEAD – Estate Planning in 2024 & Current Developments (Including Observations from Heckerling 2024) found here and Item 39.c of Estate Planning Current Developments (December 2021) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

d. **District Court and Eighth Circuit Analysis of Whether $3 Million of Insurance Proceeds Used to Redeem Decedent's Stock Should be Included in Determining Value of Decedent's Shares.** Under stipulated facts, the only valuation issue was whether the $3 million of life insurance proceeds paid to the company that were used to redeem the decedent's stock should be considered in valuing the decedent's shares for estate tax purposes.

The estate's primary argument relied on the Eleventh Circuit's opinion in *Estate of Blount v. Commissioner,* 428 F.3d 1338 (11th Cir. 2005). The district court summarized the *Blount* holding and rationale:

> The Eleventh Circuit reasoned that the stock-purchase agreement created a contractual liability for the company, offsetting the life insurance proceeds. [Citation omitted] The Eleventh Circuit concluded that the insurance proceeds were "not the kind of ordinary nonoperating asset that should be included in the value of [the company] under the treasury regulations" because they were "offset dollar-for-dollar by [the company's] obligation to satisfy its contract with the decedent's estate."

The district court in *Connelly* disagreed with the Eleventh Circuit's analysis, preferring the reasoning of the Tax Court in *Estate of Blount*: a redemption obligation is not a "value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued." A hypothetical willing buyer purchasing a company subject to a redemption obligation would not reduce the value of the company by the redemption obligation; the hypothetical buyer "would not consider the obligation to *himself* as a liability that lowers the value of the company to *him*." The district court concluded that the Eleventh Circuit's opinion in *Estate of Blount* is "demonstrably erroneous" and there are "cogent reasons for rejecting [it]."

The Eighth Circuit agreed with and expanded upon the district court's rejection of the rationale of *Estate of Blount* that the insurance proceeds were offset by the company's obligation to use the proceeds to redeem the shares.

> The IRS has the better argument. *Blount*'s flaw lies in its premise. An obligation to redeem shares is not a liability in the ordinary business sense…. Consider the willing buyer at the time of [the decedent]'s death. To own [the company] outright, the buyer must obtain all its shares. At that point, he could then extinguish the stock-purchase agreement or redeem the shares *from himself*. This is just like moving money from one pocket to another. There is no liability to be considered—the buyer controls the life insurance proceeds**.**

The Eighth Circuit added a simple example and concluded: "In sum, the brothers' arrangement had nothing to do with corporate liabilities. The proceeds were simply an asset that increased the shareholders' equity. A fair market value of Michael's shares must account for that reality."

e. **Supreme Court Review and Opinion.** The U.S. Supreme Court granted the estate's petition for a writ of certiorari (surprisingly, to most planners) on December 13, 2023. For a summary of arguments in the parties' briefs and in various amicus briefs and of observations from the oral arguments before the Court, see Item 28.e of LOOKING AHEAD – Estate Planning in 2024 & Current Developments (Including Observations from Heckerling 2024) (June 5, 2024) found here and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

U.S. Supreme Court affirmed June 7, 2024, in a unanimous opinion written by Justice Thomas. At oral argument, one Justice said he found the issues in the case "extremely difficult." The Court viewed the issue differently from *Blount*; instead of deciding whether the life insurance is included as a corporate asset in valuing the decedent's shares, the Court said that "all agree that life-insurance proceeds payable to a corporation are an asset that increases the corporation's fair market value." Instead, the issue was whether the corporation's contractual obligation to purchase the decedent's

shares "offsets the value of life-insurance proceeds committed to funding that redemption." The Court affirmed, holding that "redemption obligations are not necessarily liabilities that reduce a corporation's value for purposes of the federal estate tax." 602 U.S. ___ (June 6, 2024) (Justice Thomas, unanimous). The Court offered several reasons supporting this holding.

(3) **Fair Market Value Redemption Does Not Affect Any Shareholder's Economic Interest.** A fair market value redemption reduces the value of the corporation with a lower value, but with each remaining shareholder holding a proportionately greater percentage of that lower value. For example, if a $10 million corporation with 100 shares (worth $100,000 per share) has an 80% and 20% shareholder, assume the 20% shareholder is redeemed for $2 million. The corporation's value is reduced to $8 million, but the remaining shareholder's 80 shares are still worth $100,000 per share. "Thus, a corporation's contractual obligation to redeem shares at fair market value does not reduce the value of those shares in and of itself."

(4) **Hypothetical Buyer of Estate's Shares Would Not View Redemption Obligation as Reducing Value of the Shares.** "No willing buyer purchasing Michael's shares would have treated Crown's obligation to redeem Michael's shares at fair market value as a factor that reduced the value of those shares." At Michael's death, the company was worth $6.86 million – $3 million of insurance proceeds earmarked for the redemption and $3.86 million of other assets.

> Anyone purchasing Michael's shares would acquire a 77.18% stake in a company worth $6.86 million, along with Crown's obligation to redeem those shares at fair market value. A buyer would therefore pay up to $5.3 million for Michael's shares ($6.86 million x 0.7718)—*i.e.*, the value the buyer could expect to receive in exchange for Michael's shares when Crown redeemed them at fair market value. We thus conclude that Crown's promise to redeem Michael's shares at fair market value did not reduce the value of those shares.

(5) **Offsetting Value by Amount of Redemption Obligation Values Corporation on a Post-Redemption Basis.** A valuation that reduces the value by the redemption obligation effectively values the corporation on a "post-redemption" basis, but "for calculating the estate tax, the whole point is to assess how much Michael's shares were worth at the time that he died—before Crown spent $3 million on the redemption payment."

(6) **Cannot Reconcile Reducing Value by Amount of Redemption Obligation With Basic Mechanics of a Stock Redemption.** A redemption transaction **"**necessarily reduces a corporation's total value. And, because there are fewer outstanding shares after the redemption, the remaining shareholders are left with a larger proportional ownership interest in the less-valuable corporation." The estate argued that the corporation was worth only $3.86 million before the redemption and was worth $3.86 million after the redemption. That "cannot be reconciled with an elementary understanding of a stock redemption."

(7) **Making Succession Planning More Difficult.** The estate argued "that affirming the decision below will make succession planning more difficult" because a corporation would need policies with far more death benefits to have sufficient insurance proceeds to redeem a decedent's shares at fair market value. (Several of the amicus briefs made this same point.)

"True enough, but that is simply a consequence of [using a redemption agreement]." Other planning options are available; there are advantages and disadvantages of each of the options, but one result of the redemption arrangement is that insurance proceeds paid to the corporation that are used to fund the purchase will increase the value of the shares.

f. **Observations.**

(1) **Result Not Surprising; Makes Economic Sense Though Inconsistent With Prior Circuit Level Case.** Given the many lapses in the implementation of the Connelly redemption transaction, the taxpayer's loss is not unexpected. Including the life insurance proceeds received by a company at the decedent's death in valuing the decedent's interest in the corporation for estate tax purposes makes economic sense, as aptly summarized by the Supreme Court. Prior cases had been inconsistent; an amicus brief filed by the Chamber of Commerce of the United States of America and National Federation of Independent Business Small Business Legal

Center, Inc. discussed the IRS's shifting positions in the history of relevant cases, cited in chronological order *Newell v. Commissioner*, 66 F.2d 102 (7th Cir. 1933); *Estate of Huntsman v. Commissioner*, 66 T.C. 861, 872 (1976); *Estate of Cartwright v. Commissioner*, 183 F.3d 1034 (9th Cir. 1999); and *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005). The Court's opinion is very significant as a repudiation of the contrary holding by the Eleventh Circuit Court of Appeals in *Estate of Blount*.

The Eighth Circuit explained the "illogic" of excluding the life insurance proceeds by observing that the surviving shareholder's value would have increased from $7,720 per share (without including the life insurance proceeds to determine the value) to $33,800 per share. The survivor's shares would have quadrupled in value "without any material change to the company." "This view of the world contradicts the estate's position that the proceeds were offset dollar-by-dollar by a 'liability.' A true offset would leave the value of Thomas's share undisturbed."

Carlyn McCaffrey (New York, New York) explains using a different example. Assume a company having an operational value of $10 million is owned equally by mom and daughter, and the company is obligated to purchase the shares from the estate of a deceased shareholder at 50% of the company's value. Assume the company owns a $5 million life insurance policy on mom's life to fund the purchase of her shares at her death. At mom's death, the company receives the $5 million of life insurance proceeds. If the life insurance proceeds are not taken into account in determining the value, mom's estate will be paid 50% of $10 million, or $5 million. On the other hand, if the company had accumulated $5 million of liquid assets to fund the buyout of mom's shares at her death, the company would be worth $15 million, and the purchase price would be $7.5 million. Under the estate's position, the company can fund the buy-sell agreement purchase by paying for a life insurance policy rather than by accumulating funds, and thereby decrease the purchase price from $7.5 million to $5 million. Carlyn's reaction: "That sounds like nonsense, doesn't it?"

(2) **Buy-Sell Agreement With Life Insurance Funding.** One of the factors in determining whether to use a corporate purchase or a cross purchase arrangement in structuring a buy-sell agreement that will be funded with life insurance is that life insurance proceeds received by the company may be included in the estate tax value of a decedent's shares, resulting in escalating values of the shareholders' interests in the company. (If the purchase price is fully funded with life insurance, as each owner's interest is purchased at death using the life insurance proceeds the company value remains constant, but the remaining owners have increasing percentage interests in the entity as each owner dies, which increases the value of their interests and requires more life insurance funding.) A pricing formula that does not include the full amount of insurance proceeds payable to the company is very suspect as failing to satisfy the §2703(b) safe harbor (as evidenced by the *Connelly* district court opinion).

The economic impact of not including insurance proceeds in valuing a decedent's shares is to produce a huge windfall to the surviving shareholders. They end up owning the company free of the decedent's shares without having to pay anything following the decedent's death.

The windfall to the surviving shareholders may be greatly reduced by including the amount of the insurance proceeds on the decedent stockholder's life in the value of the corporation. However, this approach will be circular and thus greatly increase the amount of insurance coverage needed in order to fund fully the buy-sell agreement. But including life insurance proceeds in determining the value of the company following a shareholder's death reflects the economic reality of the value of the company at that time. The Supreme Court's conclusion that the estate tax value of the decedent's shares following an insured shareholder's death should reflect that economic reality is not surprising.

(3) **Buy-Sell Agreement Structuring.** A very important issue in structuring a buy-sell agreement is whether an entity purchase or cross purchase arrangement will be used. For example, the *Connelly* agreement gave the surviving shareholders the first option to purchase a decedent's shares, but if that option was not exercised, the agreement required the corporation to buy the shares.

- Entity Purchase – the parties may feel more comfortable with the entity taking steps to fund the purchase agreement rather than relying on other owners to accumulate funds (or purchase life insurance) to fund a purchase obligation, but the funding in the entity (such as life insurance) may increase the value of the entity (as in *Connelly*); for a corporation, tax considerations include whether the redemption of stock by the corporation will be given sale or exchange vs. dividend treatment.
- Cross purchase – the parties must rely on the remaining owners to purchase their interests at death, funding will be outside the entity, not increasing the entity's value at the death of an owner, and a basis step up for the units purchased will be permitted; these advantages are quite significant; if an entity has multiple owners, one approach is to have the owners form a separate partnership to own a life insurance policy on each owner's life rather than having each owner purchase a life insurance policy on each other owner's life. *See* Private Letter Ruling 200747002 (LLC owned life insurance for funding of cross-purchase buy-sell agreement of S corporation, with all shareholders of the S corporation as members of the LLC).

(4) **"Fixed and Determinable Price in the Agreement" Dictum by Eighth Circuit Suggests That Many Buy-Sell Agreements Would Not Set the Estate Tax Value.** The Eighth Circuit held that a "fixed and determinable price" was not established under the stock purchase agreement, partly because the parties did not follow the pricing mechanisms set out in the agreement. Even if those procedures had been followed, however, the Eighth Circuit suggested (presumably in dictum) that would not have been sufficient to determine the estate tax value of the stock. That observation by the court is quite significant because the pricing procedures in the buy-sell agreement in *Connelly* ((1) annual valuation agreements and (2) appraisal procedures) are often found in buy-sell agreements. A purchase under a binding agreement pursuant to those procedures might not be recognized as the value for estate tax purposes of the purchased interest under the reasoning of this dictum in *Connelly*.

The Supreme Court did not address this aspect of the Eighth Circuit opinion.

(5) **Effect of Considering Life Insurance Proceeds in Determining Value.** If a buy-sell agreement does not effectively fix the estate tax value of the stock, the corporate insurance proceeds should be considered as a factor in determining the corporation's value, and the proceeds should not merely be added to the value of the corporation determined without regard to the proceeds. *See Estate of Huntsman*, 66 T.C. 861, 872-76 (1976), *acq*. 77-1 C.B. 1 ("determine fair market value … by giving 'consideration' to the insurance proceeds"); *Newell v. Commissioner,* 66 F.2d 102, 103-04 (7th Cir. 1933) (key shareholder's estate established that stock increase was offset by decrease in corporation's value caused by loss of key shareholder).

32. Overruling of *Chevron* Doctrine Regarding the Validity of Regulations*, Loper Bright Enterprises v. Raimondo,* 603 U.S. __ (June 28, 2024)

a. **Brief Synopsis.** The Supreme Court, in a major shift of approach in analyzing the validity of actions of federal agencies (including regulations), overruled a 40-year rule announced in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). *Chevron* announced a two-step approach: (1) first, determine if a particular statutory provision is ambiguous ("the statute is silent or ambiguous with respect to the specific issue"), and if so; (2) second, the regulation would be upheld if it is a "permissible" construction of the statute, even if a court would have reached a different interpretation. The Court held that approach is inconsistent with the Administrative Procedure Act (APA), which requires "the reviewing court" to "decide *all* relevant questions of law" and "interpret statutory provisions." (emphasis added, as quoted by the Court).

In determining the validity of regulations, the "judgment of [the administrative agency] may help inform the court of the proper interpretation of the statute," but the court will determine the "best" interpretation of the statute.

> … even if some judges might (or might not) consider the statute ambiguous, there is a best reading all the same—"the reading the court would have reached" if no agency were involved. [citation to *Chevron* omitted]. It therefore makes no sense to speak of a "permissible" interpretation that is not the one the court, after applying all relevant interpretive tools, concludes is best. In the business of statutory interpretation, if it is not the best, it is not permissible.

Statutes sometime explicitly authorize an agency to interpret or provide details about implementation of a statutory provision. If so, the courts will consider if the delegation was within constitutional limits and whether the agency acted within the scope of the delegation. [*Chevron* had noted that a statute may include "express delegation of authority to the agency to elucidate a specific provision of the statute by regulation…. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute."]

Prior cases addressing the validity of agency actions that relied on the *Chevron* framework are not called into question. The holdings of those cases are subject to *stare decisis*; they may be overruled only if a "special justification" applies, and '[m]ere reliance on *Chevron* cannot constitute a "special justification….. That is not enough to justify overruling a statutory precedent."

The unofficial syllabus of the Court's decision summarized the holding very briefly:

> The Administrative Procedure Act requires courts to exercise their independent judgment in deciding whether an agency has acted within its statutory authority, and courts may not defer to an agency interpretation of the law simply because a statute is ambiguous; *Chevron* is overruled.

The majority decision concluded by summarizing its ruling as follows:

> *Chevron* is overruled. Courts must exercise their independent judgment in deciding whether an agency has acted within its statutory authority, as the APA requires. Careful attention to the judgment of the Executive Branch may help inform that inquiry. And when a particular statute delegates authority to an agency consistent with constitutional limits, courts must respect the delegation, while ensuring that the agency acts within it. But courts need not and under the APA may not defer to an agency interpretation of the law simply because a statute is ambiguous.

The Court remanded the cases to district courts to consider the appropriateness of the regulations requiring paid observers on vessels in light the Court's overruling of *Chevron*.

Tax regulations have been subject to the *Chevron* analysis, and the overruling of *Chevron* may lead to more attacks on the validity of various tax regulations.

Loper Bright Enterprises, et al. v. Raimondo, Secretary of Commerce, et al., 603 U.S. __ (June 28, 2024) (opinion by C.J. Roberts joined by J. Thomas, J. Alito, J. Gorsuch, J. Kavanaugh, and J. Barrett; separate concurring opinions by J. Thomas and J. Gorsuch; dissenting opinion by J. Kagan joined by J. Sotomayor and J. Jackson [but Justice Jackson took no part in the decision as to one of the two cases]); together with *Relentless, Inc., et al. v. Department of Commerce*, et al., Cause No. 22-1219.

b. **Summary of Analysis of Majority.**

(3) **Basic Facts.** Petitioners (commercial fishermen) in two separate cases had argued that a 1976 law requiring certain fishing vessels to carry federal observers to collect data to prevent overfishing did not authorize a 2020 regulation requiring that the boat owners pay for the observers. The D.C. Circuit and First Circuit had upheld the rules under the *Chevron* doctrine. The Supreme Court granted certiorari in both cases, "limited to the question whether *Chevron* should be overruled or clarified."

(4) **Pre-*Chevron* Brief History.** The Court began its analysis by noting that Article III of the Constitution assigns to the federal judiciary the responsibility and power to adjudicate "cases" and "controversies," and the Framers of the Constitution envisioned that the final "interpretation of laws" would be by the courts. Exercising independent judgment often included affording due respect to Executive Branch interpretations, especially when the interpretation was issued contemporaneously with the enactment of the statute and remained consistent over time. While the views of the Executive Branch could inform the judiciary, they would not supersede it.

The New Deal ushed in a rapid expansion of actions by federal agencies. The courts during that period often treated agency determinations of fact as binding on the courts if there was evidence to support the facts. But "[t]he interpretation of the meaning of statutes as applied to justiciable controversies," was "exclusively a judicial function." *United States v. American Trucking Assns., Inc.*, 310 U.S. 534, 544 (1940). Executive Branch interpretations, especially when issued contemporaneously with the enactment of a statute, were entitled to "great weight." *Id.* In L*oper Bright* the Court summarized what had come to be known as the "*Skidmore* analysis":

> **...** in *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944), the Court explained that the "interpretations and opinions" of the relevant agency, "made in pursuance of official duty" and "based upon . . . specialized experience," "constitute[d] a body of experience and informed judgment to which courts and litigants [could] properly resort for guidance," even on legal questions. *Id.*, at 139–140. "The weight of such a judgment in a particular case," the Court observed, would "depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control." *Id.*, at 140.

Congress in 1946 enacted the APA "as a check upon administrators whose zeal might otherwise have carried them to excesses not contemplated in legislation creating their offices." *United States v. Morton Salt Co.*, 338 U.S. 632, 644 (1950).

(5) **Express Delegation to Agency.** Statutes sometime give explicit authority to an agency to interpret ("give meaning to a particular statutory term") or "fill up the details" about implementation of a statutory provision. If so, the courts "interpret the statute and effectuate the will of Congress … by recognizing constitutional delegations, 'fix[ing] the boundaries of [the] delegated authority,' … and ensuring the agency has engaged in 'reasoned decisionmaking' within those boundaries." Slip Opinion at 17-18.

The Court discussed express delegation to agencies in the context of responding to an argument about policymaking:

> That is not to say that Congress cannot or does not confer discretionary authority on agencies. Congress may do so, subject to constitutional limits, and it often has. But to stay out of discretionary policymaking left to the political branches, judges need only fulfill their obligations under the APA to independently identify and respect such delegations of authority, police the outer statutory boundaries of those delegations, and ensure that agencies exercise their discretion consistent with the APA.

Slip Opinion at 26.

[*Chevron*, discussed immediately below, had noted that a statute may include "express delegation of authority to the agency to elucidate a specific provision of the statute by regulation." *Chevron* said "[s]uch legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute."]

(6) ***Chevron* Approach.** *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), announced a two-step approach for analyzing the validity of agency actions and regulations. First, determine if a particular statutory provision is ambiguous ("the statute is silent or ambiguous with respect to the specific issue"). If the statute is not ambiguous, the court should reject agency administrative constructions of statutes that were inconsistent with congressional intent. Second, if the statute is ambiguous, the regulation would be upheld if it is a "permissible" construction of the statute, even if a court would have reached a different interpretation.

> If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, [footnote omitted] as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

467 U.S. at 843.

(7) ***Chevron* is Inconsistent With APA.** The Court held that *Chevron* deference is inconsistent with the APA, which requires "the reviewing court" to "decide *all* relevant questions of law" and "interpret statutory provisions." (emphasis added, as quoted by the Court).

(a) **No Presumption of Implicit Delegation to Agencies.** Statutory ambiguities are not presumptively implicit delegations to agencies. Statutory ambiguities may arise for various reasons, including unintentional ambiguities, and that does not "reflect a congressional intent that an agency, as opposed to a court, resolve the resulting interpretive question." Slip Opinion at 22. Indeed, most ambiguities may be "unintentional," and agencies have "no special competence in resolving statutory ambiguities." Slip Opinion at 23.

> Courts, after all, routinely confront statutory ambiguities in cases having nothing to do with *Chevron*—cases that do not involve agency interpretations or delegations of authority. Of course, when faced with a statutory ambiguity in such a case, the ambiguity is not a delegation to anybody, and a court is not somehow relieved of its obligation to independently interpret the statute. … Courts instead understand that such statutes, no matter how impenetrable, do—in fact, must—have a single, best meaning. That is the whole point of having written statutes; "every statute's meaning is fixed at the time of enactment." [Citation omitted]. So instead of declaring a particular party's reading "permissible" in such a case, courts use every tool at their disposal to determine the best reading of the statute and resolve the ambiguity.
>
> In an agency case as in any other, though, even if some judges might (or might not) consider the statute ambiguous, there is a best reading all the same—"the reading the court would have reached" if no agency were involved. *Chevron*, 467 U. S., at 843, n. 11. It therefore makes no sense to speak of a "permissible" interpretation that is not the one the court, after applying all relevant interpretive tools, concludes is best. In the business of statutory interpretation, if it is not the best, it is not permissible.

Slip Opinion at 22-23.

(b) **Purported Reasons That Agency Interpretations Should Be Favored.**

i. **Subject Matter Expertise.** *Chevron* applies even in cases having little to do with the agency's technical subject matter expertise. Courts will have the benefit of the perspectives of parties and *amici* (both are "steeped in the subject matter") and the agency's subject matter expertise (its "body of experience and informed judgment"). The agency's interpretation may be "especially informative" when it rests on "factual premises" within its expertise.

> For those reasons, delegating ultimate interpretive authority to agencies is simply not necessary to ensure that the resolution of statutory ambiguities is well informed by subject matter expertise. The better presumption is therefore that Congress expects courts to do their ordinary job of interpreting statutes, with due respect for the views of the Executive Branch. And to the extent that Congress and the Executive Branch may disagree with how the courts have performed that job in a particular case, they are of course always free to act by revising the statute.

Slip Opinion at 25.

ii. **Uniform Construction of Federal Law.** "[T]here is little value in imposing a uniform interpretation of a statute if that interpretation is wrong." Slip Opinion at 25.

iii. **Policymaking Suitable for Political Actors.** "Courts interpret statutes. No matter the context, based on the traditional tools of statutory construction, not individual policy preferences." Slip Opinion at 26.

(c) **Many Exceptions to *Chevron* Have Been Applied.** "[W]e have spent the better part of four decades imposing one limitation on *Chevron* after another, pruning its presumption …. Confronted with this byzantine set of preconditions and exceptions, some courts have simply bypassed *Chevron*, saying it makes no difference for one reason or another." Slip Opinion at 27-28.

(d) **Stare Decisis.** Stare decisis does not require persisting with the *Chevron* doctrine.

> The only question left is whether *stare decisis*, the doctrine governing judicial adherence to precedent, requires us to persist in the *Chevron* project. It does not. *Stare decisis* is not an "inexorable command," …, and the *stare decisis* considerations most relevant here—"the quality of [the precedent's] reasoning, the workability of the rule it established, . . . and reliance on the decision," …—all weigh in favor of letting *Chevron* go.

Slip Opinion at 29.

(8) **Effect on Prior Cases.** Prior cases addressing the validity of agency actions that relied on the *Chevron* framework are not called into question. The holdings of those cases are subject to *stare decisis*; they may be overruled only if a "special circumstance" exists, and '[m]ere reliance on *Chevron* cannot constitute a "special justification…. That is not enough to justify overruling a statutory precedent." Slip Opinion at 34-35.

The dissent speculates that future courts will find ways to relook at the validity of regulations addressed in those prior cases because of the overruling of *Chevron*:

> The majority says that a decision's "[m]ere reliance on *Chevron*" is not enough to counter the force of *stare decisis*; a challenger will need an additional "special justification." ... The majority is sanguine; I am not so much. Courts motivated to overrule an old *Chevron*-based decision can always come up with something to label a "special justification." Maybe a court will say "the quality of [the precedent's] reasoning" was poor.... Or maybe the court will discover something "unworkable" in the decision—like some exception that has to be applied.... All a court need do is look to today's opinion to see how it is done.

Slip Opinion, Dissent at 31.

(9) **Summary.** The very end of the majority opinion has an excellent brief summary of how courts will analyze the validity of agency rules and regulations in the future:

> *Chevron* is overruled. Courts must exercise their independent judgment in deciding whether an agency has acted within its statutory authority, as the APA requires. Careful attention to the judgment of the Executive Branch may help inform that inquiry. And when a particular statute delegates authority to an agency consistent with constitutional limits, courts must respect the delegation, while ensuring that the agency acts within it. But courts need not and under the APA may not defer to an agency interpretation of the law simply because a statute is ambiguous.

Slip Opinion at 35.

c. **Concurring Opinions.** A concurring opinion by Justice Thomas maintains that *Chevron* deference is constitutionally suspect. "I write separately to underscore a more fundamental problem: *Chevron* deference also violates our Constitution's separation of powers." Slip Opinion, Thomas Concurring at 2. A lengthy concurring opinion by Justice Gorsuch observes that the majority opinion "places a tombstone on *Chevron* no one can miss" and explains his view of "why the proper application of the doctrine of *stare decisis* supports [overruling *Chevron*]. Slip Opinion, Gorsuch Concurring at 1-2.

d. **Dissenting Opinion.** A dissenting opinion by Justice Kagan, joined by Justices Sotomayor and Jackson (Justice Jackson participated only in one of the two case) gives various reasons why *Chevron* deference is appropriate and criticizes overruling this 40-year doctrine. Some of the reasons given include the following.

(3) **Fill Statutory Gaps.** Agency action is needed to fill gaps or ambiguities in statutes.

(4) **Subject Matter Expertise of Agencies.**

> [A]gencies often know things about a statute's subject matter that courts could not hope to. The point is especially stark when the statute is of a "scientific or technical nature." [citation omitted]. Agencies are staffed with "experts in the field" who can bring their training and knowledge to bear on open statutory questions. *Chevron*, 467 U. S., at 865. Consider, for example … [w]hen does an alpha amino acid polymer qualify as a "protein"? ... I don't know many judges who would feel confident resolving that issue. (First question: What even *is* an alpha amino acid polymer?) But the FDA likely has scores of scientists on staff who can think intelligently about it, maybe collaborate with each other on its finer points, and arrive at a sensible answer.

Slip Opinion, Dissent at 9.

(5) **Experience with Complex Regulatory Regimes.** "Congress would value the agency's experience with how a complex regulatory regime functions, and with what is needed to make it effective." Slip Opinion, Dissent at 10. For example, a statute may require adjusting Medicare reimbursements for geographic wage differences. Many variables could impact that analysis including hard data, the ease of administering approaches on a nationwide basis, how regulators have dealt with similar questions in the past, and what hospitals think would work best.

"Congress knows the Department of Health and Human Services can do all those things—and that courts cannot." Id.

(6) **Policy Issues.** A regulatory decision may be "less one of construing a text than of balancing competing goals and values… Again, that is a choice a judge should not be making, but one an agency properly can. Agencies are 'subject to the supervision of the President, who in turn answers to the public.'" [citation omitted] Slip Opinion, Dissent at 11.

(7) **Summary of Those Issues.**

> [The majority opinion] insists that "agencies have no special competence" in filling gaps or resolving ambiguities in regulatory statutes; rather, "[c]ourts do." ... Score one for self-confidence; maybe not so high for self-reflection or -knowledge. Of course courts often construe legal texts, hopefully well. [Several specific regulatory issues are listed.] The idea that courts have "special competence" in deciding such questions whereas agencies have "no[ne]" is, if I may say, malarkey. Answering those questions right does not mainly demand the interpretive skills courts possess. Instead, it demands one or more of: subject-matter expertise, long engagement with a regulatory scheme, and policy choice. It is courts (not agencies) that "have no special competence"—or even legitimacy—when those are the things a decision calls for.

Slip Opinion, Dissent at 13.

(8) ***Chevron* Deference Has Been Fine-Tuned.**

> None of this is to say that deference to agencies is always appropriate. The Court over time has fine-tuned the *Chevron* regime to deny deference in classes of cases in which Congress has no reason to prefer an agency to a court. The majority treats those "refinements" as a flaw in the scheme, … but they are anything but.

Slip Opinion, Dissent at 11.

(9) **APA is Compatible With Chevron Deference.** The dissent addresses the majority's reference to the APA dictating that courts should "decide all relevant questions of law."

> The majority highlights the phrase "decide all relevant questions of law" (italicizing the "all"), and notes that the provision "prescribes no deferential standard" for answering those questions. ... But just as the provision does not prescribe a deferential standard of review, so too it does not prescribe a *de novo* standard of review (in which the court starts from scratch, without giving deference). In point of fact, Section 706 does not specify *any* standard of review for construing statutes. [citation omitted] And when a court uses a deferential standard—here, by deciding whether an agency reading is reasonable—it just as much "decide[s]" a "relevant question[] of law" as when it uses a *de novo* standard. §706. The deferring court then conforms to Section 706 "by determining whether the agency has stayed within the bounds of its assigned discretion—that is, whether the agency has construed [the statute it administers] reasonably." [citing a Harvard Law Review article]. [S]ee *Arlington v. FCC*, 569 U. S. 290, 317 (2013) (ROBERTS, C. J., dissenting) ("We do not ignore [Section 706's] command when we afford an agency's statutory interpretation *Chevron* deference; we respect it").

Slip Opinion, Dissent at 16.

(10) **Abandonment of *Stare Decisis*.** The dissent, in particular, decries the overruling of *Chevron* as subverting the principle of *stare decisis* and threatening the interests of parties who have relied for years on agency regulations (some of which may have specifically been upheld by the courts under Chevron deference).

> And still there is worse, because abandoning *Chevron* subverts every known principle of *stare decisis*. Of course, respecting precedent is not an "inexorable command." *Payne* v. *Tennessee*, 501 U. S. 808, 828 (1991). But overthrowing it requires far more than the majority has offered up here. *Chevron* is entitled to *stare decisis*'s strongest form of protection. The majority thus needs an exceptionally strong reason to overturn the decision, above and beyond thinking it wrong…. In particular, the majority's decision today will cause a massive shock to the legal system, "cast[ing] doubt on many settled constructions" of statutes and threatening the interests of many parties who have relied on them for years. [*Kisor v. Wilkie*,] 588 U. S., at 587 (opinion of the Court).
>
> …
>
> On the other side of the balance, the most important *stare decisis* factor—call it the "jolt to the legal system" issue—weighs heavily against overruling *Chevron*…. [P]rivate parties have ordered their affairs—their business and financial decisions, their health-care decisions, their educational decisions—around agency

> actions that are suddenly now subject to challenge. In *Kisor*, this Court refused to overrule *Auer* [which requires judicial deference to agencies' interpretations of their own regulations] because doing so would "cast doubt on" many longstanding constructions of rules, and thereby upset settled expectations. 588 U. S., at 587 (opinion of the Court). Overruling *Chevron*, and thus raising new doubts about agency constructions of statutes, will be far more disruptive.

Slip Opinion, Dissent at 24, 30.

(11) **Effect on Prior Decisions.** The dissent responded to the position in the majority opinion "that judicial decisions that have upheld agency action as reasonable under *Chevron* should not be overruled on that account alone" by observing that "courts motivated to overcome an old Chevron-based decision can always come up with something to label a 'special justification.' … All a court need do is look at today's opinion to see how it is done." Slip Opinion, Dissent at 30-31.

(12) **No Reliance on *Chevron* For Sixteen Years.** The majority opinion observed that the Supreme Court had not relied on *Chevron* for 16 years. The dissent viewed that as a bootstrap because it reflects an effort over that 16-year period by some Justices ultimately to overrule *Chevron*.

> The majority says differently, because this Court has ignored *Chevron* lately; all that is left of the decision is a "decaying husk with bold pretensions." … The majority's argument is a bootstrap. This Court has "avoided deferring under *Chevron* since 2016" [cross reference citation omitted] because it has been preparing to overrule *Chevron* since around that time. That kind of self-help on the way to reversing precedent has become almost routine at this Court. Stop applying a decision where one should; "throw some gratuitous criticisms into a couple of opinions"; issue a few separate writings "question[ing the decision's] premises" [cross reference citation omitted]; give the whole process a few years . . . and voila!—you have a justification for overruling the decision…. I once remarked that this overruling-through-enfeeblement technique "mock[ed] *stare decisis*." *Janus* [*v. State, County, and Municipal Employees*], 585 U. S., at 950 (dissenting opinion). I have seen no reason to change my mind.

Slip Opinion, Dissent at 27.

e. **Observations.**

(3) **Overview Regarding Estate Tax Regulations.** 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 applied the *Chevron* deference test to determine whether this "interpretive regulation" was reasonable (as opposed to the stricter "arbitrary, capricious, or manifestly contrary to the statute" test for "legislative regulations" issued under a specific grant of authority in the pertinent statute). The court said that it did not need to reach the issue of whether the regulation was adopted in violation of the APA. The holding in *Walton* 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 (thus almost or perhaps completely "zeroing out" the GRAT). After focusing on the statute's "origin and purpose for further guidance," *Walton* viewed the restriction in Example 5 from netting the gift amount by the value of the reversionary interest passing to the donor's estate as "an unreasonable interpretation and an invalid extension of section 2702." 115 T.C. at 604.

Since that time almost twenty-five years ago, very 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.

(4) **Continuation of Recent Trend Attacking Regulations; Statute of Limitations Regarding Attacks on Old Regulations (*Corner Post, Inc. v. Board of Governors of the Federal Reserve System*).** *Loper Bright* is the latest link in a chain of recent attacks on the validity of regulations. See Item 25 above for discussion about a number of recent cases beginning in late 2021 that have addressed the validity under the APA of regulations and other IRS guidance (not only for final regulations but also temporary regulations and even subregulatory guidance).

Indeed, the Supreme Court followed *Loper Bright* with an opinion several days later saying that the six-year statute of limitations "after the right of action first accrues" under 28 U. S. C.

§2401(a) for claims against the United States would not bar attacks on even very old regulations as being in violation of the Administrative Procedure Act requirements for valid agency actions. The Court concluded that the six-year statute does not begin to run until a particular plaintiff is injured by agency action. *Corner Post, Inc. v. Board of Governors of the Federal Reserve System*, 603 U.S. __, 2024 WL 3237691 (July 1, 2024) (J. Barrett writing for majority; Dissent by J. Jackson, jointed by J. Sotomayor and J. Kagan). Section 2401(a) of the APA has a six-year statute of limitations to challenge a final agency action. A practical problem with that limit is that the Anti-Injunction Act (§7421(a)) prevents challenges to tax regulations until a taxpayer is affected (i.e., has a notice of deficiency, a refusal of a refund, or other dispute with the IRS). *CIC Services LLC v. United States*, 593 U.S. 209 (2021). That may be far longer than six years after the regulation was finalized. When taxpayers have challenged some regulations, the government has argued that the statute of limitations had run under §2401(a) on the taxpayer's ability to challenge the regulation's validity. Under *Corner Post*, old regulations may still be challenged, as long as the challenge is brought within six years of when a taxpayer is injured by the regulation. Some commentators suggest that "*Corner Post* is a much bigger deal for tax than *Loper Bright*," with its opening of old regulations to challenges. *See* Sheppard, *Supreme Court Reverses* Chevron *Doctrine*, 184 TAX NOTES FEDERAL 379 (July 15, 2024).

(5) **General Application to Tax Regulations.** *Mayo Foundation v. U.S.*, 562 U.S. 44 (2011), regarding the validity of a Treasury regulation that impacted a requested refund of FICA taxes, specifically held that *Chevron* deference applies to tax regulations. "[W]e are not inclined to carve out an approach to administrative review good for tax law only.… The principles underlying our decision in *Chevron* apply with full force in the tax context." 562 U.S. at 55. *Mayo Foundation* rejected an argument that tax matters should be treated differently than other areas of administrative law. That meant that issues that had been raised regarding agency interpretations prior to *Chevron* (such as whether agency interpretation had been consistent, had been promulgated years after the relevant statute was enacted, because of the way in which the regulation evolved, or because the regulation was prompted by litigation) would not apply to the Court's review of the FICA regulation.

(6) **Effect of Specific Statutory Authorization for Regulations**. Many Treasury regulations have been promulgated pursuant to the Treasury Department's general authority under §7805 to "prescribe all needful rules and regulations for the enforcement of" the Internal Revenue Code. Prior to *Chevron*, several Supreme Court cases said the Court owed less deference to the Treasury Department's interpretation that is issued under that general authority in §7805(a) than when it is issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision. *Rowan Cos.* v. *United States*, 452 U.S. 247, 253 (1981); *United States* v. *Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982) (quoting *Rowan*). That changed, however, following the *Chevron* case. *Mayo Foundation* stated that the administrative landscape changed significantly after *Rowan* and *Vogel* were decided. 562 U.S. at 56.

> We have held that *Chevron* deference is appropriate "when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority." [*United States v. Mead Corp.*], 533 U. S., at 226–227. **Our inquiry in that regard does not turn on whether Congress's delegation of authority was general or specific.**

562 U.S. at 56-57 (emphasis added).

That statement by the Supreme Court in 2011, drawing no distinction between general or specific delegations of authority to the Treasury Department in tax statutes, appears to be a change in the position taken by the Court in *Chevron*, which applied a high standard for disregarding "legislative regulations" in response to "an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. According to *Chevron*, such legislative regulations were given controlling weight unless they were arbitrary, capricious, or manifestly contrary to the statute." *Chevron*, 467 U.S. 837, at 843-844 (1984). Various cases after *Chevron* have drawn a distinction between interpretive regulations issued under the general

authority of §7805(a) and legislative regulations issued under a specific grant of authority for a particular statute.

For example, the Tax Court in *Walton v. Commissioner*, 115 T.C. 589 (2000), invalidated the notorious "Example 5" in the initial GRAT regulations by applying a "reasonable manner" standard for interpretive regulations, as opposed to the much stricter "arbitrary, capricious, or manifestly contrary to the statute" standard for reviewing legislative regulations.

> The regulations at issue here are interpretative regulations promulgated under the general authority vested in the Secretary by section 7805(a). Hence, while entitled to considerable weight, they are accorded less deference than would be legislative regulations issued under a specific grant of authority to address a matter raised by the pertinent statute. See Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843-844 (1984) (Chevron); United States v. Vogel Fertilizer Co., 455 U.S. 16, 24 [49 AFTR 2d 82-491] (1982). A legislative regulation is to be upheld unless "arbitrary, capricious, or manifestly contrary to the statute." Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., supra at 843-844.
>
> With respect to interpretative regulations, the appropriate standard is whether the provision "implement[s] the congressional mandate in some reasonable manner." United States v. Vogel Fertilizer Co., supra at 24 (quoting United States v. Correll, 389 U.S. 299, 307 [20 AFTR 2d 5845] (1967)). In applying this test, we look to the following two-part analysis enunciated by the Supreme Court [in *Chevron*].

115 T.C. at 597.

Other cases (prior to *Loper Bright*) have acknowledged that the issuance of a regulation after following the notice-and-comment procedures of the APA are a "significant" sign that the regulation merits *Chevron* deference. *Mayo Foundation*, *United States v. Mead Corp.*, *Long Island Care at Home Ltd. v. Coke*.

The Court *in Loper Bright* did not specifically address the effect of general vs. specific statutory authority for issuing regulations. The Court acknowledged that different types of statutory authority may exist for issuing regulations.

> In a case involving an agency, of course, the statute's meaning may well be that the agency is authorized to exercise a degree of discretion. Congress has often enacted such statutes. For example, some statutes "expressly delegate[]" to an agency the authority to give meaning to a particular statutory term. *Batterton* v. *Francis*, 432 U. S. 416, 425 (1977) (emphasis deleted). Others empower an agency to prescribe rules to "fill up the details" of a statutory scheme, *Wayman* v. *Southard*, 10 Wheat. 1, 43 (1825), or to regulate subject to the limits imposed by a term or phrase that "leaves agencies with flexibility," *Michigan* v. *EPA*, 576 U. S. 743, 752 (2015), such as "appropriate" or "reasonable." [footnotes omitted]

Slip Opinion at 17.

The Court did not refer to how its analysis would vary depending on the type of statutory authorization other than to recognize that courts should determine the boundaries of the delegated authority and ensure "that the agency has engaged in 'reasoned decisionmaking' within those boundaries." Slip Opinion at 18. The end of the majority's opinion in *Loper Bright* merely observes that "when a particular statute delegates authority to an agency consistent with constitutional limits, courts must respect the delegation, while ensuring that the agency acts within it. But courts need not and under the APA may not defer to an agency interpretation of the law simply because a statute is ambiguous." The only limitations specifically mentioned is that the courts "must respect the delegation" and must determine that regulations that are issued are within the scope of the delegated authority. However, some commentators believe that under *Loper Bright*, regulations issued pursuant to a specific grant of authority will continue to be afforded more weight than mere interpretive regulations issued under §7805's general grant of authority. *E.g.*, Mitchell Gans & Jonathan Blattmachr, *Loper Bright Enterprises v. Raimondo, Where in a Generational Shift, the Supreme Court Overruled the Chevron Doctrine*, LEIMBERG ESTATE PLANNING NEWSLETTER #3130 (July 2, 2024) (hereinafter Gans & Blattmachr, Generational Shift).

All tax regulations are issued under the general authority of §7805, stating that "the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal

revenue." But some regulations are also issued under more specific statutory authority, typically included in the relevant Code provision.

For example, Ron Aucutt (Lakewood Ranch, Florida) points to the "consistent basis" proposed regulations. Section 1014(f) specifically authorizes regulation to "provide exceptions to the application of this subsection." Mr. Aucutt asks: "Does that permit regulations that assign a zero basis to an after-discovered or accidentally omitted asset, even though its value has been neither "determined" under §1014(f)(1)(A) nor reported under §1014(f)(1)(B) and therefore it appears that §1014(f) does not apply to that asset at all? I don't think so." In contrast, §6035 requires providing basis information to recipients, and §6035(b) authorizes regulations that are "necessary to carry out" §6035. Mr. Aucutt points out that Treasury officials have informally cited §6035(b) "to perhaps justify requiring the successive reporting by donors and other transferors in non-realization transfers, but §6035 only requires reporting and does not assign basis like §1014(f) does. Moreover, even §6035(b)'s use of 'necessary' may be viewed as weak compared to the 'necessary or appropriate' standard in §2001(g)(2) (clawback) and §2010(c)(6) (portability)."

Relatively very few of the Code sections regarding estate and gift taxes include specific statutory authorization for regulations. Some exceptions include §2001(g)(2) (clawback, "necessary or appropriate"), §2010(c)(6) (portability, "necessary or appropriate"), §2014(c)(2) foreign tax credit, "regulations prescribed by the Secretary"), §2016 (recovery of taxes claimed as credit, "regulations prescribed by the Secretary"), §2014(c)(2) foreign tax credit, "regulations prescribed by the Secretary"), §2032A(f)(1) (special use valuation statute of limitations, "such manner as the Secretary may be regulations prescribe"), §2037(b)(2) (value of reversionary interest, "regulations prescribed by the Secretary"), §2053(d)(1) (deductibility of certain foreign death taxes, "regulations prescribed by the Secretary"), §2055(e)(H) (estate tax charitable deduction, "as may be necessary to carry the purposes of this paragraph"), §2056A(a)(2) and (e) (qualified domestic trusts, "may by regulations prescribe to ensure the collection of any tax imposed by subsection (b)" and "[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section"), §2108(d) (application of pre-1967 estate tax provisions regarding taxes paid to foreign country, "necessary or appropriate to implement this section"), §2204(b) (discharge of fiduciary from personal liability, "for purposes of carrying out the provisions of this section as the Secretary may require by regulations"), §§2513 (a)(2), 2513(b), and 2513(c) (split gift election, "such manner as is provided under regulations"), §2522(e)(1)(B) (gift tax charitable deduction limitations for fractional gifts, "may, by regulation, provide"), §2522(e)(2)(A) (gift tax charitable deduction recapture, "Secretary shall provide"). That leaves most of the estate and gift tax Code sections with no specific authorization for regulations. Section 2663 authorizes regulations "as may be necessary or appropriate" regarding all the generation-skipping transfer tax Code provisions (and specifically including three listed topics). In summary, **very few** estate and gift tax regulations have been issued pursuant to specific statutory authority other than the general authority of §7805.

For an outstanding discussion of the importance of whether and how courts may restrict the scope of express delegations to write regulations, see Jasper Cummings, Chevron: *How to Read a Supreme Court Opinion*, TAX NOTES (Oct. 2, 2024).

(7) **Review Standards Prior to *Chevron (Skidmore and National Muffler)*.** Before the *Chevron* decision in 1984, courts had typically used the review standards originally announced by the Supreme Court in 1944 in *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944):

> We consider that the rulings, interpretations and opinions of the Administrator under this Act, while not controlling upon the courts by reason of their authority; do constitute a **body of experience and informed judgment** to which courts and litigants may properly resort for guidance. The weight of such a judgment in a particular case will depend upon **the thoroughness** evident in its consideration, the **validity of its reasoning**, its **consistency** with earlier and later pronouncements, and all those factors which give it **power to persuade**, if lacking power to control.

323 U.S. at 140 (emphasis added).

Factors mentioned by *Skidmore* (in the quotation immediately above) that courts should consider in determining what weight to give to agency interpretations in looking to them for "guidance" are (1) their thoroughness, (2) the validity of their reasoning, (3) their consistency with earlier and later pronouncements, and (4) all factors relevant to their power to persuade.

The Supreme Court subsequently summarized *Skidmore* as saying an agency's interpretation of a statute is entitled to "respect proportional to its 'power to persuade.'" *United States v. Mead Corp.*, 533 U.S. 218, 235 (2001) (quoting *Skidmore*).

The *Skidmore* analysis was applied with more detail by the Supreme Court in *National Muffler Dealers Assn. v. United States*, 440 U.S. 472 (1979).

> In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation **harmonizes with the plain language of the statute, its origin, and its purpose**. A regulation may have particular force if it is a **substantially contemporaneous** construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a **later period, the manner in which it evolved merits** inquiry. Other relevant considerations are the **length of time** the regulation has been in effect, the **reliance** placed on it, the **consistency** of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during **subsequent re-enactments of the statute**.
>
> …
>
> In short, while the Commissioner's reading of 501(c)(6) perhaps is not the only possible one, it does bear a fair relationship to the **language of the statute**, it reflects the **views of those who sought its enactment**, and it matches **the purpose** they articulated. It **evolved as the Commissioner administered the statute** and attempted to give to a new phrase a content that would reflect congressional design. The regulation has **stood for 50 years**, and the Commissioner infrequently but **consistently** has interpreted it to exclude an organization like the Association that is not industrywide. The Commissioner's view therefore merits serious deference.

440 U.S. at 477-78 (emphasis added).

(8) **Does the *Skidmore* Review Standard Apply Following *Loper Bright*?** *Loper Bright* does not specifically address what standard should be used by courts in reviewing whether regulations appropriately interpret statutory provisions. Some commentators have suggested that following *Loper Bright*, courts will consider "the relevant factors under *Skidmore* deference." *E.g.*, Gans & Blattmachr, Generational Shift. Other commentators believe that the standard to be applied after the overruling of *Chevron* is not clear. *See Skidmore Deference: Agency Actions Without the Force of Law*, BLOOMBERG LAW (July 2024) ("The *Skidmore* standard was cited in the briefs in *Loper Bright* and *Relentless*, and was the subject of questions during oral argument as well. It's a frontrunner to be a *Chevron* replacement, though nothing is certain yet.").

One commentator believes that the *Skidmore* framework will be applied, observing that it is not "deference" to agency interpretation (*Loper Bright* emphasizes that courts interpret and construe statutes and should never "defer" to agency interpretations) but is a process for "uncovering statutory meaning."

> … [I]in *Loper Bright* the Court not only cited *Skidmore* with seeming approval, but repeatedly emphasized the "respect" traditionally afforded to longstanding, consistent agency interpretations, especially when offered close in time to the statute's passage….
>
> … But it doesn't want to call *Skidmore* "deference," because it believes the thing called deference is not allowed under the APA. And so we also get some language endorsing de novo review.
>
> … *Skidmore* is really about uncovering statutory meaning. So, the *Loper Bright* majority might say, using it does not constitute deference any more than consulting a dictionary does. *Chevron* was different in that it was premised on the idea that the law had "run out," and the agency simply got to decide the question. *Loper Bright* seems to embrace something like this distinction in footnote 3.

Daniel Deacon, *Loper Bright, Skidmore, and the Gravitational Pull of Past Agency Interpretations*, BLOG FROM YALE JOURNAL ON REGULATION AND AMERICAN BAR ASSOCIATION ADMINISTRATIVE LAW AND REGULATORY PRACTICE SECTION (June 30, 2024).

The contrast between the "uncovering statutory meaning" approach of *Skidmore* and the "deference" approach of *Chevron* was explained in Ryan Doerfler, *How Clear is "Clear"?*, 109 VA. L. REV. 651, 709 (2023) ("unlike *Chevron*, however, *Skidmore* appears to treat an agency's views as evidence of statutory meaning…. Again, under *Skidmore*, an agency's views are evidence of statutory meaning. Under *Chevron*, by contrast, those views constitute a legal basis for deciding a case if statutory meaning is unknown.").

(9) **Possible Practical Implications of *Loper Bright* on Tax Regulations Going Forward.**

(a) **More Attacks on Validity of Regulations.** The overruling of *Chevron* deference will allow much more flexibility to courts in reviewing the validity of regulations and whether they correctly reflect the "plain language…, … origin, and … purpose" (quoting *National Muffler*) of pertinent statutes, likely leading to more attacks on the validity of regulations. "No longer will the IRS be entitled to a near-automatic win if it can establish that the statute is ambiguous. No longer is it a *fait accompli* that a court will uphold a challenged regulation." Thomas Sykes, Loper Bright: *A Tax Litigator's Quick Take*, 184 TAX NOTES FEDERAL 451 (July 15, 2014) (hereinafter Sykes, Tax Litigator's Quick Take). (In addition, the recent court attacks under the APA on a conservation easement tax regulation will likely lead to more litigation about the validity of regulations under the APA. See Item.25 above.)

Examples of tax regulations that may be subject to attack (or that already are under attack) include the Bipartisan Budget Act's partnership audit regime, conservation easements, the partnership anti-abuse rule in Reg. §1.701-2, the "blocked income regulation" (Reg. §1.482-1(h)(2)) under §482 (the reflection of income statute in the international context), and the repatriation regulation (Reg. §1.965-5(c)(1)(ii)) that denied credit for some foreign income taxes. *See* Sheppard, *Supreme Court Reverses* Chevron *Doctrine*, 184 TAX NOTES FEDERAL 379 (July 15, 2024); Sapirie, Chevron *is Dead. Long Live* Skidmore *and the APA?*, 184 TAX NOTES FEDERAL 393 (July 15, 2024). If the forthcoming proposed regulations described in Notice 2024-54 regarding partnership basis-shifting transactions are issued and finalized, they may be subject to attack. *See Business Group Says No Authority for Basis-Shifting Transaction Rules*, TAX NOTES (July 16, 2024) (comments to IRS regarding Notice 2024-54 from Alliance for Business Partnerships).

Another example is the regulatory requirement of the timing for updating information on beneficial ownership reports under the Corporate Transparency Act. Updates or corrections of reports must be made within 30 days of changes (not within 30 days of when the reporting company learns of a change). However, the statute merely requires that updating of reports must be filed "in accordance with regulations prescribed by the Secretary of the Treasury, … in a timely manner, and not later than 1 year after the date on which there is a change." 31 U.S. CODE §5336(b)(1)(D). Courts may address whether a 30-day timeline is the "best reading" of the statutory requirement of "a timely manner, and not later than 1 year after the date on which there is a change," and that decision would include an analysis of the scope of the authorization for regulations.

> Obviously, the foreshortened deadline, however helpful to Treasury's Financial Crimes Enforcement Network, is a trap for tens of millions of small business owners just trying to stay afloat — owners who perhaps have little contact with professional advisers. That is dubious public policy and antithetical to the textually expressed congressional intent.

Sykes, Tax Litigator's Quick Take.

(b) **Procedural Details for Challenges.** Procedural details regarding challenges of the validity of a regulation are summarized.

> If a practitioner concludes that a Treasury regulation is possibly invalid under *Loper Bright*, it might make sense to file a refund claim, depending on the amount of tax involved in open and future tax years. A taxpayer ordinarily has three years from when a return was filed, or two years from when tax was paid, to file a timely and sufficient refund claim detailing the facts and grounds on which the taxpayer is relying. [Footnote citing §6511.] Both the Internal Revenue Manual and case law provide that a taxpayer who wishes to have the IRS take no action on a refund claim that is premised on the outcome of

> pending litigation (perhaps brought by others) may file a protective claim for refund within the applicable limitations period.
>
> If the IRS has disallowed a refund claim, a taxpayer generally has two years within which to file suit in U.S. district court or the Court of Federal Claims, [footnote citing §6501] unless the taxpayer previously signed a Form 2297, "Waiver of Statutory Notice of Claim Disallowance," in which case the two years begins to run when that form is signed. A taxpayer who has received a notice of deficiency from the IRS has only 90 days to file its petition in Tax Court, and that deadline may not be extended. If the taxpayer wishes to challenge a dubious regulation, the challenge should be teed up in the taxpayer's petition.
>
> Any original return, refund claim, Tax Court petition, or similar document that is premised on a position that contradicts a Treasury regulation should, out of an abundance of caution, be accompanied by a Form 8275-R, "Regulation Disclosure Statement," disclosing the conflict and detailing the basis for the taxpayer's position. This will help protect the taxpayer from possible penalties if the challenge is rejected.
>
> Tax practitioners should not overlook the recent activity around the six-year "outer limit" limitations statute found in 28 U.S.C. section 2401(a). If a taxpayer could have, but did not, mount a court challenge to a regulation within six years after its promulgation, a court challenge may be barred. That is, taxpayers sometimes don't bother to challenge a regulation because the tax liability stemming from its application is insufficient to warrant the expense and effort. If, however, the tax at stake increases sharply in a future tax year, a challenge at that time might make financial sense. But at that point, if the six-year limit of section 2401(a) has passed, would the IRS assert that section 2401(a) bars the challenge, despite the various other tax-specific limitations periods found in the code? [Footnote citing *Corner Post* (six-year limit starts to run when a litigant is adversely affected by the regulation).]

Sykes, Tax Litigator's Quick Take.

(c) **Attacks on Regulations Previously Found to be Valid Under the *Chevron* Standard.** The majority in *Loper Bright* attempted to clarify that prior cases addressing the validity of agency actions that relied on the *Chevron* framework are not called into question. The dissent, however, expressed that courts would still find a way to re-examine prior cases by finding the existence of some "special circumstance" to overcome the *stare decisis* doctrine. See Item 30.b(6) above.

(d) **Less Changing of Agency Interpretations in Regulations.** Courts may be much less inclined to give weight to agency interpretations that are inconsistent with prior interpretation. Inconsistency is a negative factor under *Skidmore*. At oral argument in *Loper Bright*, some Justices were particularly concerned with the power that *Chevron* gave agencies to "change their minds."

> It's evident from the opinions (as well as oral argument) that what perhaps most bugged some of the justices about the *Chevron* regime was the ability it gave agencies to change their minds. This aspect of the new doctrine may dissuade agencies from doing so, even if they think they have pretty good support for the new interpretation.

Daniel Deacon, *Loper Bright, Skidmore, and the Gravitational Pull of Past Agency Interpretations*, BLOG FROM YALE JOURNAL ON REGULATION AND AMERICAN BAR ASSOCIATION ADMINISTRATIVE LAW AND REGULATORY PRACTICE SECTION (June 30, 2024).

Agencies may be less inclined to rewrite or eliminate prior regulations "when a new administration takes office." Gans & Blattmachr, Generational Shift (observing that *Loper Bright* reiterated that "every statute's meaning is fixed at the time of enactment").

(e) **Perhaps More Emphasis on Revenue Rulings Than on Regulations.** The Gans & Blattmachr article notes that regulations enjoyed substantial deference under *Chevron*, whereas revenue rulings enjoyed much less deference under the *Skidmore* standard.

> With Chevron now overruled and regulations and rulings both subject to Skidmore, perhaps the IRS will decide to issue more revenue rulings and less regulations though the IRS's argument in favor of a regulation will be somewhat stronger, even under Skidmore, given the notice-and-comment procedure.

Gans & Blattmachr, Generational Shift. *See also* Slowey, *The Ripple Effect of Chevron Doctrine: Tax Fallout, Explained*, BLOOMBERG DAILY TAX REPORT (July 15, 2024) ("The agency

may decide it's not worth that regulation if the rule will be in the hands of the courts anyway.").

(f) **Less Declaring Victory by Regulation Following Court Losses.** The Gans & Blattmachr article also points out that the issuance of a regulation in the heat of litigation (such as the "anti-Hubert" regulations) is a negative factor regarding regulation validity under *Skidmore*.

(g) **IRS Position in Administrative Proceedings.** *Loper Bright* may have an impact on the IRS's stance in an administrative proceeding regarding an issue governed by an existing regulation and its position regarding settlement. *See* Sykes, Tax Litigator's Quick Take.

(h) **Taxpayer's Approach For a Position in Tension With Existing Regulation.** Taxpayers will consider how they will move forward (or abandon) a position in conflict with an existing regulation regarding the taxpayer's position (1) on a return, (2) in an administrative proceeding, or (3) in litigation. *See Id*.

(i) **Treasury's Approach in Issuing New Guidance.** Treasury may reassess how it will proceed regarding a position in new regulations that may be questioned as to whether it is the "best meaning" of the approach contemplated by the statute. *See Id*.

(j) **Congress's Approach in Structuring Legislation.** *Loper Bright* may place more focus on structuring legislation to provide implementation details rather than risking how courts may interpret details as to the "best meaning" of a statute and how it should be implemented. Special attention will be devoted to any express delegation to Treasury in tax statutes to provide "needful rules and regulations" (§7805(a)). Courts will carefully analyze the scope of any such express delegation of rulemaking authority and whether Treasury has engaged in "reasoned decisionmaking" within those boundaries. See Item 30.e(4) above.

The Joint Committee on Taxation may play an even larger role going forward in crafting tax legislation and producing detailed legislative history.

> The decision in *Loper Bright Enterprises v. Raimondo* holds big implications for tax policy, as Congress often gives the IRS and the Treasury Department leeway to fill in gaps in tax laws when crafting final regulations.
>
> Now, the House Ways and Means and Senate Finance committees may need to be more specific in delegating authority to the agencies and produce more detailed legislative histories for the courts to understand what Congress intended. Some lawmakers have said they may need backup from key partners like the Joint Committee on Taxation, which works closely with tax writers analyzing the impact of tax proposals.
>
> "The bulk of that is going to go on the Joint Committee staff, if Congress is serious in writing bills that they actually want to do and not letting the courts rewrite it," said George Yin, who served as the chief of staff at the JCT from 2003 to 2005.
>
> …
>
> Depending on how courts approach the legal challenges, there may be a greater emphasis on the legislative history and committee reports that the JCT is a key player in drafting, said Steve Rosenthal, a senior fellow at the Urban-Brookings Tax Policy Center who previously served as a legislation counsel at JCT.
>
> Congress will need help from JCT in choosing how to delegate authority to the IRS and Treasury and explaining the context, but JCT is prepared to take on that task, Rosenthal said.

Handler, *Congress's Tax Scorekeeper Gets Spotlight After Chevron Ruling*, BLOOMBERG DAILY TAX REPORT (July 23, 2024).

(10) **Summaries of Transformative Effect of *Loper Bright* on Administrative Law.** The Gans & Blattmachr article concludes with an observation about the transformative effect of *Loper Bright*:

> Loper is a transformative decision. It will dramatically alter administrative law, severely diminishing the interpretive authority of the agencies and giving it to the courts instead. The impact will be substantial on all manner of regulation. In the tax area, taxpayers faced with problematic regulations will now have a stronger argument in terms of their validity.

A summary of *Loper Bright* by Miller & Chevalier (a law firm headquartered in Washington D.C. with substantial experience in legislative and administrative law matters) concludes with a discussion of the unsettling and dramatic impact of *Loper Bright*:

> The impact of *Loper Bright* on federal courts and agencies, Congress, and parties challenging agency action cannot be underestimated. The opinion will surely give rise to an increase in legal challenges to agency regulations and administrative actions and in forum shopping by litigants wishing to get those cases before their desired judges and circuit courts. Federal agencies will lose the significant advantage in those cases that *Chevron* deference afforded them and they will likely take additional steps in issuing guidance and rulemaking to shore up the foundation and persuasiveness of their regulatory actions.
>
> It will take years for the rebalancing of federal government power over the administrative state to fully take shape following *Chevron*'s demise. Because district and appellate courts will exercise independent judgment when interpreting ambiguous legislation and undoubtedly will not see eye to eye on many issues, some laws federal agencies are charged to implement and enforce will be more unsettled for both regulated parties and those agencies. This uncertainty will create both burdens and opportunities for regulated parties.

(11) **Proposed Legislation to Codify *Chevron* Doctrine.** Eleven Democratic Senators on July 23, 2024, introduced the Stop Corporate Capture Act to codify the *Chevron* doctrine. The 35-page bill includes a wide variety of detailed requirements. Following is a link to the press release describing the legislation, which has links to the bill text and a section-by-section description of the bill. Very similar proposed legislation was introduced as H.R. 1507 in March 2023.

33. Section 2036 Applied to "Eve of Death" Funding of Limited Partnership by Decedent's Agent, *Estate of Fields v. Commissioner*, T.C. Memo 2024-90 (Sept. 26, 2024, corrected opinion issued Nov. 4, 2024)

a. **Synopsis.** Decedent's grand-nephew (N) acting under a power of attorney for decedent transferred about $17 million of assets (all of her assets except $1.5 million of liquid assets and $600,000 of illiquid assets) to a limited partnership (LP) in return for a 99% limited partnership interest. N owned the LLC that was the 1% general partner. The LP and LLC were created and funded when decedent was in "end stages" of Alzheimer's disease, and she died less than a month after the LP was funded (the largest asset contributed was transferred just 10 days before her death, after the decedent had been placed in hospice care). The assets retained by the decedent were not sufficient to satisfy her debts, cash bequests in her will, and estate taxes.

On these facts, it is not surprising that the court determined that the LP assets were included in the decedent's estate under §2036.

(1) §2036(a)(1): Acting through N as her agent, the decedent had access to the transferred assets (because N owned the LLC that was the general partner, which could control distributions from the LP); use of a significant portion of LP assets to pay various debts and expenses after one's death is evidence of a retained interest.

(2) §2036(a)(2): The partners unanimously could dissolve the LP, so the decedent (through N as her agent), in conjunction with others, could obtain the assets and then designate their disposition, citing *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017).

(3) The bona fide sale for adequate consideration exception to §2036 did not apply. The adequate consideration requirement was met (citing the test from *Kimbell v. United States*, 317 F.3d 257, 266 (5th Cir. 2004)), but the bona fide sale requirement was not met because there was no nontax reason as a significant purpose for creating the LP. Nontax reasons asserted by the estate were: (a) preventing financial elder abuse; (b) providing for management succession; (c) avoiding difficulties of managing assets under a power of attorney; and (d) streamlining of management.

The court listed eight reasons those were not viewed as actual purposes for creating the LP, including: (a) lack of planning prior to the decedent's precipitous declining health; (b) lack of contemporaneous documentary evidence of motivations for the transaction other than the attorney's reference to "obtaining deeper discounts"; (c) absence of business interests requiring active management; and (d) depletion of liquidity to the point post-death obligations could not be paid.

The §2043 analysis from *Estate of Moore v. Commissioner*, T.C. Memo 2020–40, was applied (but did not result in additional estate inclusion because the assets did not appreciate between the time of funding the LP and the time of death).

A 3.5% block of thinly traded company stock was entitled to an illiquidity discount, but the IRS's expert's 5.7% discount rather than the taxpayer's expert's 10% discount was used (because the IRS expert had a more detailed analysis of 32 transactions of private sales of restricted stock that could not be sold for 6-12 months and analogized that to a large block of stock).

The court applied the 20% penalty under § 6662(a) & (b)(1) for underpayments attributable to negligence or disregard of rules or regulations. The reasonable cause and good faith exception did not apply. A reduction of $6.2 million in value by interposing an LP interest between the decedent and her assets "on the eve of death would strike a reasonable person in [N's] position as very possibly being too good to be true." Therefore, reasonable cause would not exist absent good faith reliance on professional tax advice, but there was no specific evidence that any professional advised that the assets could be reported at the claimed discount.

Estate of Fields v. Commissioner, T.C. Memo 2024-90 (September 26, 2024, corrected opinion issued Nov. 4, 2024) (J. Copeland)

b. **Observations.**

(3) **Overview of §2036.** Section 2036(a)(1) requires estate inclusion of assets transferred with a retained right to possession or enjoyment of, or the right to income from the property.

Section 2036(a)(2) requires estate inclusion of property transferred with "the right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the [transferred] property or the income therefrom."

An exception applies under §2036, however, for a "bona fide sale for an adequate and full consideration in money or money's worth."

(4) **Action Under Power of Attorney on the Eve of Death; Decedent's Agent Controlling Distributions as General Partner.** The funding of an LP by an agent under a power of attorney on the eve of death is pretty uniformly the "kiss of death" against §2036 arguments. One of the facts causing estate inclusion under §2036(a)(1) was that N was the decedent's agent under a power of attorney and was also the owner of the LLC that was the general partner of the LP, and the general partner made distribution decisions for the LP. Therefore, decedent, through N as her agent, had access to all the LP assets, and the documents reflect an express retention of access to transferred assets.

(5) **Implied Retained Access to Pay Post-Death Obligations Is Sufficient to Invoke §2036(a)(1); Other Cases (But Not All) Have Also Applied This Reasoning; Planning Considerations**. Cases uniformly have held that a retained interest under §2036(a)(1) does not have to be express but can be implied. Although the decedent likely retained enough liquid assets outside the LP ($1.5 million) to cover her anticipated living expenses (due to her short life expectancy), the court reasoned that the necessity of obtaining distributions from the LP by the estate to cover post-death obligations (including cash bequests and estate taxes) demonstrated an implied agreement of retained enjoyment of the assets transferred to the LP.

Whether needing to access LP assets to satisfy post-death obligations triggers §2036(a)(1) has been addressed in many cases, with varying results. Attorneys have argued in various cases that post-death use of partnership assets should not be used as evidence of retained enjoyment by the decedent (§2036 refers to retained enjoyment by the decedent for life or for any period before death), but various cases have viewed the use of partnership assets to pay post-death obligations as reflecting retained enjoyment under §2036(a)(1). Those cases are *Rosen*, *Korby*, *Thompson*, *Erickson*, *Jorgensen*, *Miller*, *Liljestrand*, *Rector*, and *Beyer* (Tax Court cases) and the *Strangi* Fifth Circuit Court of Appeals case. *Miller* and *Erickson* are two cases in which the court looked primarily to post-death distributions and redemptions to pay estate taxes as triggering §2036(a)(1). In *Erickson*, T.C. Memo. 2007-107, the court emphasized particularly that the

partnership provided funds for payment of the estate tax liabilities. (The only liabilities mentioned in the case were gift and estate tax liabilities.) The court viewed that as tantamount to making funds available to the decedent. Although the disbursement was implemented as a purchase of assets from the estate and as a redemption, "the estate received disbursements at a time that no other partners did. These disbursements provide strong support that Mrs. Erickson (or the estate) could use the assets if needed."

Interestingly, Judge Chiechi (the trial court judge in *Beyer*) was not troubled by post-death payments of estate taxes and other liabilities of the decedent's estate in *Estate of Mirowski v. Commissioner*. In *Mirowski*, the LLC distributed $36 million to the decedent's estate to pay transfer taxes, legal fees, and estate obligations. The court observed that the decedent's death was not anticipated at the time of the transfers, and there was no understanding to make LLC distributions to pay the taxes or other amounts due after her death. A distinction in *Mirowski* is that the decedent held a 52% interest in the LLC at her death that would have been sufficient to support the $36 million of distributions, but the distribution was not accomplished by purchasing assets from the decedent's estate or redeeming her interest in the LLC.

What if there are non-liquid assets in the estate and insufficient liquid assets for paying all post-death expenses? John Porter (Houston, Texas) has these recommendations:

(a) It is best is to borrow from a third party, but a bank may be unwilling to make a loan using only the partnership interest as collateral. The bank may want a guarantee by the partnership. If so, partnerships should be paid a guarantee fee. There is a legitimate reason for the LP to give a guarantee, because there will be an IRS lien against the partnership, and the partnership will not want the bank to foreclose on a partnership interest.

(b) Borrow from an insurance trust or a family entity, secured by the partnership interest.

(c) There are three options for utilizing partnership funds: redemption, distribution or loan. *Erickson* involved a purchase of assets and redemption but held against the taxpayer. Pro rata distributions are a possibility, but if they are made on an "as needed basis" that plays into the IRS's hands on the §2036 issue; the estate can argue that distributions for taxes are made all the time from partnerships, but usually for income taxes. John Porter prefers borrowing from the partnership on a bona fide loan, using the partnership interest as collateral. It is best to use a commercial rate rather than the AFR rate (that looks better to the government as an arm's length transaction).

Some attorneys suggest that the preferred approach is to have other family members or family entities purchase some of the decedent's partnership interest to generate cash flow to the estate for paying post-death expenses, so that the necessary cash never comes directly from the partnership.

(6) **Roadmap to Flunking Bona Fide Transfer Requirement.** The reasons given by the court as to why the stated nontax reasons were not significant reasons motivating the creation of the LP provide a roadmap of what to avoid in planning. The court discussed the following eight reasons:

- No discussion of creating the LP until the eve of death;
- No changes in the assets, suggesting that no need for management existed before the LP's creation;
- No financial elder abuse other than what had occurred years earlier;
- No contemporaneous documentary evidence of motivations for creating the LP other than the attorney's reference to "obtaining a deeper discount";
- No pooling of assets for joint enterprise or obvious creation of synergies;
- No business interests requiring active management;
- All transactions by the agent, with the decedent not involved in any planning; and

- A depletion of liquidity to the point that the estate could not pay cash bequests or estate taxes.

(7) **Incorporates Groundbreaking Analysis from Relatively Recent §2036 Cases; *Estate of Powell* and *Estate of Moore*.** The *Estate of Fields* case incorporates the reasoning and approach of several groundbreaking cases in the last several years.

Estate of Fields applies the analysis in *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017), which applied §2036(a)(2) to a situation in which the partners could act unanimously to dissolve the partnership because the decedent could act "in conjunction with others" to designate who could enjoy the partnership assets. The "alone or in conjunction with" analysis has been the focus of various cases in the last several years following the *Powell* case. For a discussion of *Powell*, *Cahill*, *Morrissette*, and *Levine* regarding the §2036(a)(2) issue, see Item 17 of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** For further discussion of ways to avoid the *Powell* issue, see Item 11.l(5) above.

Estate of Fields is the first case to repeat and rely on the analysis in *Estate of Moore v. Commissioner*, T.C Memo. 2020-40, of the interaction of §2033, §2036, and §2043. (That analysis of §2043 had been described briefly in *Powell v. Commissioner*.) Under the §2043 analysis, a person may have more estate inclusion by creating an LP than if the person had just retained the assets outright. Under the *Estate of Moore* analysis, the net value included in the gross estate under §2033, §2036, and §2043 is stated algebraically as V = A+B-C, where:

A is the estate's interest in the partnership (at its date of death discounted value) (included in the gross estate under §2033);

B is the date of death value (undiscounted) of the assets contributed to the LP (included in the gross estate under §2036); and

C is the discounted value of the partnership interest received when assets were contributed to the LP (subtracted under §2043.)

In *Moore*, because the decedent died only 27 days after the partnership was funded and because there was no evidence the asset values changed in that time period, "A" and "C" in the formula cancelled each other out, so the value included in the gross estate was the date of death value of the assets contributed to the partnership[(undiscounted).

The effect, compared to not creating the LP and continuing to own all the assets outright, is that extra inclusion may result to the extent the date of death discounted value of the LP interest exceeds the date of funding discounted value of the partnership interest. For a detailed discussion of the §2043 analysis in *Estate of Moore*, see Akers & Aucutt, *Estate of Moore v. Commissioner Summary* (April 2020) available **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

34. Step Transaction Doctrine Discussed in Connection with Purported Life Insurance Proceeds Inclusion Because of Alleged Lack of Insurable Interest, *Estate of Becker v. Commissioner,* T.C. Memo. 2024-89 (Sept. 24, 2025)

a. **Basic Facts.** The decedent loaned money to an irrevocable life insurance trust (Trust) to pay $1.7 million premiums on two life insurance policies with a combined death benefit of $19.5 million. The decedent borrowed that $1.7 million from the insurance agent who in turn borrowed it from another lender. Three months later the notes (secured by the policies) were assigned to a third party entity that committed to advance loans for future premiums (the third party entity never actually advanced additional loans). The decedent died unexpectedly in a car accident about a year and a half afterward, and the $19.5 million of death proceeds were paid to the Trust.

b. **IRS Position.** The IRS argued that the third party entity did not have an insurable interest in the policies and under Maryland law, the insured's estate was entitled to the death proceeds. However, the Trust that initially acquired the polices had an insurable interest, and under Maryland law a

subsequent assignment of the policy would be legal whether or not the person had an insurable interest. Despite those Maryland law issues, the IRS argued that the estate was the beneficiary of the policy under a convoluted step transaction doctrine argument.

c. **Step Transaction Doctrine.** The step transaction doctrine has been applied under any of three separate tests:

(3) **"Binding Commitment Test."** "At the time that the first step is undertaken, the taxpayer was under a formal commitment to complete the remaining steps, often when a substantial period has passed between the steps that are subject to scrutiny."

(4) **"End Result Test."** "[T]ransactions will be collapsed if it appears that a series of formally separate steps are really prearranged parts of a single transaction intended from the outset to reach the ultimate result." This is a "subjective test that focuses on the parties' actual intent at the time that the transaction was entered into."

(5) **"Interdependence Test."** "The steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."

(6) **Application to Facts.** None of those tests applied.

(a) The parties agreed that the "binding commitment test" did not apply (in part because there was no substantial period of time between the separate steps).

(b) The "end result test" did not apply because the third party "was unidentified at the time the … policies were issued."

(c) The "interdependence test" did not apply because no additional premiums would be required for 30 months, the decedent had enough assets to continue loans to the Trust to pay future premiums, and invoking the commitment by the third party to advance loans for payment of future premiums was not necessary.

d. **Court's Conclusion.** The step transaction doctrine does not apply. "Rather, the picture that emerges is that, of several financing options available to [the decedent] and the Trust to secure funding for possible future premiums, they simply chose the option that they viewed to be the most financially beneficial." There was no violation of Maryland's insurable interest doctrine, and the estate had no claim to the insurance proceeds, so there was no estate inclusion.

e. **Interesting Aside.** The financing agreement with the third party entity that committed to make advances to the Trust to pay future premiums provided that the third party would be repaid its advances plus interest **plus 75% of the policy proceeds**. Why would anyone agree to that??? The third party argued after the decedent's death that it was entitled to $14.8 million of the $19.5 million of the death proceeds; it eventually settled for $9 million (and it never actually advanced any additional funds to the Trust).