Estate Planning Current Developments and Hot Topics

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Introduction

The 51st Annual Philip E. Heckerling Institute on Estate Planning was held in Orlando during the week of January 9, 2017. This summary includes observations from that seminar, as well as other observations about various current developments and interesting estate planning issues from throughout 2017.

1. Summary of Top Developments in 2017

Ron Aucutt (Washington D.C.), provides the following as his "top ten" list of the major developments in the estate planning world in 2017:

(1) The 2017 Tax Act (see Item 2.c-e below)

(2) Regulatory environment in the Trump administration (see Item 2.b below);

(3) An extreme family limited partnership case (the *Powell* case, see Item 15.g below);

(4) Withdrawal of the proposed regulations under §2704 (see Item 6 below);

(5) Continued tension between Congress and the IRS;

(6) Developments with portability on several fronts (including Rev. Proc. 2017-34, and the *Sower* and *Vose* cases, se Item 16.d-e below);

(7) Growing legislative acceptance of asset protection trusts;

(8) Measured retroactive relief for same-sex married couples (Notice 2017-15);

(9) Decline of state estate taxation); and

(10) Challenges to the substantiation of charitable contributions, including conservation easements.

Aucutt, *Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2017*, McGuireWoods Website (posted January 11, 2018).

2. 2017 Tax Act and Tax Reform

a. **Estate Tax Repeal History-1986 Tax Reform Act; Proposals for 2017.** Estate tax repeal has been considered by various administrations. One staffer from 1986 has stated that negotiation of the momentous 1986 Tax Reform Act came down to one last item. The legislative staffers told President Reagan that he could get rid of the estate tax, but he would have to give up the B-2 bomber. President Reagan replied that he would rather keep the B-2 bomber.

The House Republican Blueprint for Tax Reform published June 24, 2016 included a proposal to repeal the estate and GST tax (but presumably to retain the gift tax). President Trump's campaign proposal was to "repeal the death tax, but capital gains held until death and valued over $10 million [presumably that is per couple] will be subject to tax to exempt small businesses and family farms." The 2017 Tax Act, as described below, does not repeal the estate and GST tax but roughly doubles the estate and gift tax exclusion amount for 2018-2025.

b. **Legislative Process for Tax Reform Using Reconciliation**. The process for getting tax reform legislation in 2017 was using the budget reconciliation act. The Congressional Budget Act of 1974 (Titles I – IX of the Congressional Budget and Impoundment Control Act of 1974) modified and clarified the role of Congress in the federal budgetary process. It governs the process of annual budget resolutions and budget reconciliations. Title II created the Congressional Budget Office (CBO) to give Congress independent economic analysis; previously the Executive Branch controlled budgetary information. Standing budget committees in the House and Senate were created and additional staffing was authorized for committees involved with budget decisions.

(1) **Budget Resolution**. Title III specifies procedures for the adoption of an annual budget resolution, which is a concurrent resolution that is not signed by the President, that sets out fiscal policy guidelines for Congress (but Congress does not adopt a budget resolution in all years, for example it did not do so last year). (The budget resolution cannot be filibustered in the Senate.) The budget resolution does not enact spending or tax law, but sets targets of overall receipts and expenditures, based on CBO estimates, for other committees that can propose legislation changing spending or taxes. The limits on revenue and spending that it establishes may be enforced in Congress under "points of order" procedural objections (which requires 60 votes in the Senate to waive). Budget resolutions set spending and revenue levels for a budget window (at least five years but typically 10 years). The budget resolution typically is rather straightforward, primarily stating how much should be spent in each of 19 broad spending categories, and specifying how much total revenue the government will collect for each year in the budget window.

The House passed its budget resolution on October 5, 2017 on a mostly party-line vote. The House budget include $203 billion in mandatory spending cuts and tax changes that do not add to the national debt, but the Senate budget included much fewer mandatory spending cuts and authorized a $1.5 trillion reduction of federal revenues over the ten-year budget window. Senator Corker emphasized that the $1.5 trillion deficit agreement was merely to get a budget resolution passed, and that he would still want revenue neutrality over the budget window after applying a reasonable "dynamic scoring" approach before he will vote in favor of the tax legislation in a reconciliation act. *See* Erik Wasson, *GOP Budget Kicks Off Effort on Tax Cuts. Now Comes the Hard Part,* DAILY TAX REPORT (October 5, 2017). But he subsequently agreed with the tax reform package, discussed below, despite the revenue impacts.

(2) **Reconciliation Act**. 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) with very limited opportunity for amendment. The reconciliation bill, when ultimately approved by the House and Senate, goes to the President for approval or veto.

The reconciliation process has proved instrumental in being able to pass measures connected with the budget process without the necessity of garnering 60 votes in the Senate. For example, reconciliation was instrumental in the passage of the 2001 and 2003 tax cuts, healthcare reform in 2010, and welfare reform in 1996.Tax reform will not necessarily have to be subject to a 10-year sunset provision (what some planners refer to as a "sunrise" provision) if 60 votes cannot be secured in the Senate if the overall package does not add to the deficit outside the budget window of the act. Some significant tax acts have been passed under the reconciliation process without the sunset provision by finding other "pay-fors" so that net tax revenue decreases do not exceed net outlay decreases outside the budget window. (That was accomplished with the 1997 tax act, but that was in a time of budget surpluses.)

(3) **Byrd Rule**. While the reconciliation act is not subject to Senate filibuster, under the "Byrd rule" (added permanently as §313 of the Congressional Budget Act in 1990) 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—one of which is an entitlement increase or tax cut that will cost money beyond the budget window of the reconciliation bill (typically ten years) unless other provisions in the bill fully offset these costs. (The actual language of the Congressional Budget Act is cumbersome, stating that

> a provision shall be considered to be extraneous if it increases, or would increase, net outlays, or if it decreases, or would decrease, revenues during a fiscal year after the fiscal years covered by such reconciliation bill or reconciliation resolution, and such increases or decreases are greater than outlay reductions or revenue increases resulting from other provisions in such title in such year. 2 U.S. CODE §644(b)(1)(E).)

The offending provision is automatically stripped from the bill unless at least 60 Senators waive the rule. (In congressional vernacular, reviewing a reconciliation act to determine if any extraneous provisions exist is referred to as giving the proposed legislation a "Byrd bath," and any items that are dropped to avoid having extraneous provisions are called "Byrd droppings.") The Senate parliamentarian makes the decision as to what provisions violate the Byrd rule. The Vice President, as the presiding officer of the Senate, can override the parliamentarian's decision, but "the long-standing Senate precedent is to defer to the parliamentarian's rulings." Steven Dennis & Laura Litvan, *Senate GOP to Snub House Obamacare Repeal Fill, Write Its Own*, BNA DAILY TAX REPORT (May 5, 2017). (For example, Democrats believed the provision in the House bill to repeal and replace the Affordable Care Act that let states apply for waivers to allow insurers to charge higher premiums to people with pre-existing conditions if they haven't maintained continuous coverage, provided the state also has a high-risk pool, violated the Byrd rule and could not have been included in the Senate version of the health care reconciliation act without 60 votes. *Id*.)

If the legislation does not result in revenue neutrality after the budget window, the classic approach is to sunset the offending measures at the end of the budget window (which is why the "Bush tax cuts" in 2001 only lasted for ten years), thus resulting in tax reform measure or tax cuts that would not violate the Byrd rule and that could be passed with a mere majority in the Senate.

The 2017 Tax Act (discussed below) generally sunsets most of the individual and transfer tax provisions (not including, among other things, the chained CPI approach for indexing) after 2025 to avoid having a 60-vote requirement in the Senate under the Byrd Rule.

c. **Overview of 2017 Tax Act**.

(1) **Passage of "Tax Cuts and Jobs Act" (or Reconciliation Act of 2017 or 2017 Tax Act)**. The Tax Cuts and Jobs Act passed the House on December 19, 2017 by a vote of 227-203 (with no Democratic votes and with 13 Republican members from California, North Carolina, New Jersey, and New York voting no). The Senate parliamentarian ruled that three provisions in the version passed by the House were "extraneous" to reconciliation (one of which was removing the short title, discussed in the following paragraph) and were removed in the bill that passed the Senate very early in the morning of December 20 by a straight party-line vote of 51-48 (Senator McCain was absent), forcing a House revote of the version passed by the Senate later that same morning. The President signed Public Law No. 115-97 (the "Act") on December 22, 2017.

The short title "Tax Cuts and Jobs Act" was removed, but the Act may continue informally to be referred to by that former and commonly used name. The official title is "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." Perhaps the Act will be known as the Reconciliation Act of 2017 or simply as the 2017 Tax Act.

(2) **Effective Date**. Most of the provisions are effective for taxable years beginning after 2017. Most of the provisions regarding individual tax reform (including the transfer tax provisions) are effective for taxable years from 2018-2025 (i.e., for 8 years). They sunset after that date in order to satisfy the "Byrd rule" so that the Act could be passed with just a majority vote in the Senate under the reconciliation process. The change to the "Chained CPI" indexing approach remains permanent, and generally the business tax reform measures are permanent.

(3) **Simplification.** One of the stated purposes of tax reform was simplification, but many of the provisions add significant complexity. In particular, the various limitations and restrictions on the 20% deduction for pass-through entity qualified business income are very complicated.

(4) **Revenue Impact**. The budget resolution that initiated the reconciliation process for approving the Act (with only a majority vote requirement in the Senate) authorized tax reform that would produce no more than $1.5 trillion of deficits over the 10-year budget window authorized in the budget resolution. The Joint Committee on Taxation scored the bill as producing $1.456 trillion of deficits over the 10-year period. It did not provide a "dynamic scoring" estimate taking into consideration economic gains that would result from the Act. The Tax Foundation (a "right-leaning" organization) estimates that the Act would add $1.47 trillion to the deficit over 10 years, but $448 billion after considering economic growth. The individual tax

provisions of the Act generally sunset after 8 years; the Tax Foundation estimates that making all of the bill's tax cuts permanent would have resulted in a deficit of $2.7 trillion over 10 years, or $1.4 trillion considering economic growth. Accordingly, the sunset provision saves $1.23 trillion ($2.7 - $1.47 trillion) with a static projection, or $950 billion ($1.4 - .448 trillion) considering economic gains, and the trend of increasing deficits would have continued to expand in the following decade. Tax Foundation, *Preliminary Details and Analysis of the Tax Cuts and Jobs Act* (Dec. 2017). These estimates of the impact of the sunset provisions suggest that for Congress to remove the sunset provisions before 2026 could raise significant additional deficit concerns, increasing the cost of the Act **over *just the following two years* by almost $1 trillion** (even considering economic growth), let alone going forward permanently. Accordingly, planning will need to take into consideration the significant possibility that the sunsetting of the individual provisions (including the transfer tax provisions) will occur.

d. **Transfer Tax Issues**.

(1) **Basic Exclusion Amount Doubled; Other Indexed Amounts**. The Act increases the basic exclusion amount provided in §2010(c)(3) from $5 million to $10 million (indexed for inflation occurring after 2011) for "estates of decedents dying, generation-skipping transfers, and gifts made" after 2017 and before 2026. The indexed amount for 2018 using the new "chained CPI" approach is not yet known. Dan Evans (Philadelphia, Pennsylvania) estimates that the basic exclusion amount for 2018 will be $11.18 million and that the other previously announced indexed amounts for 2018 will remain the same under the chained CPI approach: annual gift tax exclusion – $15,000; annual gift tax exclusion for non-citizen spouses – $152,000; limitation on special use valuations – $1,140,000; and "2% portion" under §6166 – $1,520,000. Daniel Evans, *Summary of the Reconciliation Act of 2017*, (Dec. 25, 2017); **http://resources.evans-legal.com/?p=5316**.

The legislative history for the Act (the Joint Explanatory Statement of the Committee of Conference, referred to in this summary as the "Joint Explanatory Statement") refers to this change as doubling the "estate and gift tax exemption," but it also doubles the GST exemption because §2631(c) states that the GST exemption is "equal to the basic exclusion amount under section 2010(c)."

The sunsetting of the doubled basic exclusion amount raises the prospect of exclusions decreasing, and taxpayers being motivated to make transfers to take advantage of the larger exclusion amount, as in late 2012, but only significantly wealthy individuals are likely to be concerned with the gift tax exclusion amount decreasing to $5 million (indexed).

(2) **Regulations Will Address "Clawback."** The Act amends §2001(g) to add a new §2001(g)(2) directing the Treasury to prescribe regulations as may be necessary or appropriate to address any difference in the basic exclusion amount at the time of a gift and at the time of death. This is to deal with the possibility of a "clawback" – i.e., a prior gift that was covered by the gift tax exclusion at the time of the gift might

result in estate tax if the estate tax basic exclusion amount has decreased by the time of donor's death, thus resulting in a "clawback" of the gift for *estate* tax purposes. This is the same issue that was a concern in 2012 when the possibility existed of the gift tax exclusion amount being reduced from $5 million (indexed) to $1 million. Most commentators thought there was unlikely to be a "clawback" in that situation; indeed, Congressional staffers had indicated in 2012 that clawback was not intended.

Unfortunately the calculation procedure described in the Instructions to the Form 706 would have resulted in a "clawback." (Section 2001(g) was added in 2010 to clarify that in making the second calculation under §2001(b)(2)), the tax **RATES** in effect at the date of death (rather than the rates at the time of each gift) are used to compute the gift tax imposed and the gift unified credit allowed in each year, but §2001(g) does not specify whether to use the exclusion amount at the date of the gift or at the date of death for multiplying by the date of death rate to determine the gift credit amount in making the second calculation.)

The estate tax calculation method under § 2001(b) is as follows:

- Step 1: calculate a tentative tax on the combined amount of (A) the taxable estate, and (B) the amount of adjusted taxable gifts (i.e., taxable gifts made after 1976 other than gifts that have been brought back into the gross estate — just the tax using the rate schedule is calculated, without subtracting any credits). I.R.C. §2001(b)(1).
- Step 2: subtract the amount of gift tax that would have been payable with respect to gifts after 1976 if the rate schedule in effect at the decedent's death had been applicable at the time of the gifts, I.R.C. § 2001(b)(2). The statute does not say whether to use the gift credit amount that applied at the time of the gift or at the time of death — and this is what leads to the uncertainty. Form 706 instructions for the "Line 7 Worksheet" specifically state that the basic exclusion amount *available in each year using a Table of Basic Exclusion Amounts provided for each year from 1977 to 2017* (plus any applicable DSUE amount) that gifts were made is used in calculating the gift tax that would have been payable in that year. The effect of this calculation is that the tentative tax on the current estate plus adjusted taxable gifts would not be reduced by any gift tax payable on those gifts if the gifts were covered by the applicable exclusion amount during the years that gifts were made. In effect, the tentative estate tax would include a tax on the prior gifts.
- Step 3: Subtract the estate tax applicable credit amount.

The apparent intent of the Act is that regulations would clarify that clawback would *not apply* if the estate exclusion amount is smaller than an exclusion amount that applied to prior gifts.

Presumably, the regulations would also address a potential "reverse clawback problem" that could arise when exemption amounts are increasing. Assume a donor makes a $2 million gift in a year in which the gift exemption amount is only $1 million, but the estate tax exemption amount later increases to $5 million. In making the estate tax calculation, if the hypothetical gift tax payable on the $1 million gift is merely based on the exemption amount in the year of death, there would be no hypothetical gift tax on the $2 million gift, so there would be estate tax imposed on the full estate plus adjusted taxable gifts, without any credit for the gift tax *that was actually paid* on the $2 million gift. One possible approach to avoid that potential problem would be the legislative "fix" that was proposed in the Sensible Estate Tax Act of 2011 (H.R. 3467, §2(c)), which would have calculated the hypothetical gift tax payable on the adjusted taxable gift (which is subtracted in determining the estate tax) using the gift credit amount that applied in the year of the gift, *but not exceeding* the estate tax applicable credit amount in the year of death. Therefore, the higher exemption amount would not be used in calculating the hypothetical gift tax payable.

A more detailed statutory provision that addressed the clawback issue in a different manner was in the 2012 Middle Class Tax Cut Act (S. 3393, §201(b)(2)

For a further discussion of the clawback issue, see James G. Blase, "Clawback Under New Tax Law" *Trusts & Estates* (Dec. 27, 2017); ***http://www.wealthmanagement.com/estate-planning/clawback-under-new-tax-law***.

(3) **No Estate Tax Repeal**. The House version of the Act would have repealed the application of the estate tax to decedents dying after 2024 (but would have left in place references to chapter 11 in §1014(b) for basis adjustment purposes at a decedent's death). The House version would have left the gift tax in place, but with a reduction in the rate to 35% after 2024.

e. **Individual Income Tax Issues**.

(1) **Rate Brackets**. The Act preserves seven tax brackets, with a top rate of 37% for income starting at $500,000 (indexed) for single individuals and heads of households and at $600,000 (indexed) for married individuals filing joint returns. (The applicable income levels for the top rate bracket results a "marriage penalty" of about $8,000 for taxpayers in the top bracket.) The brackets are revised significantly. As an example, a married couple filing jointly with taxable income of $700,000 would pay $222,431 under pre-Act law and would pay $198,379 under the Act (ignoring any applicable credits).

The top rate for trusts and estates applies to taxable income in excess of $12,500 (indexed). (Under pre-Act law, the top rate bracket for trusts and estates would have applied to taxable income in excess of $12,700 in 2018.)

(2) **Indexing Using "Chained CPI."** A different measure of inflation will be used for indexing. The "chained CPI" approach would put more taxpayers in higher brackets over time than under the current indexing approach (and it continues to apply even after the tax changes for individuals sunset after 2025). The chained CPI approach uses the Department of Labor Chained Consumer Price Index for All Urban Consumers ("C-CPI-U") rather than the "CPI-U" index that is used under pre-Act law. Values that are reset for 2018 are indexed with the chained CPI index in taxable years beginning after 2018. Unlike most of the other provisions applicable to individual taxpayers, changing to the chained CPI indexing approach does not sunset after 2025.

The IRS is expected to publish revised inflation adjustments for 2018 using the chained CPI index sometime in January or February, 2018.

(3) **Standard Deduction and Personal Exemption**. The standard deduction is increased to a deduction of $24,000 for married individuals, and the personal exemption is eliminated. The net result of these two changes will produce a modest tax savings for some (but not all) taxpayers. Under pre-Act law, in 2018 the standard deduction for married couples would have been $13,000 and the personal exemption would have been $4,150 so the combined standard deduction and personal exemptions for a married couple would have been $13,000 + 4,150 + 4,150, or $21,300 for a couple without children, or $25,450 for a couple with one child.

Because of the increased standard deduction and the fact that many deductions for individuals are eliminated or limited (as discussed below), many taxpayers will use the standard deduction and will not realize any income tax benefits from charitable contributions, home mortgage interest payments, state and local tax payments, or other payments still qualifying as deductions to those who itemize deductions. Very importantly for business owners, as discussed above, the 20% deduction for qualified business income is allowed in addition to the standard deduction.

Taxpayers may consider "bunching" deductions into a particular year. For example, a taxpayer might make large charitable contributions in a single year to a donor advised fund, which can be implemented with very little expense or administrative inconvenience by creating an account with an established donor advised fund at a financial institution, community foundation, or other institutional sponsor. The account could be used to fund annual charitable contributions that the taxpayer would otherwise make in later years. The taxpayer could itemize deductions in the year in which the large payments are made, and use the increased standard deduction in other years.

The aged (age 65 and older) or blind deduction under §63(f) is not eliminated. The Joint Explanatory Statement describes the Senate version: "The additional standard deduction for the elderly and the blind is not changed by the provision," and the Conference Agreement followed the Senate amendment. The aged or blind indexed deduction has previously been announced as being $1,300 ($1,600 for an unmarried person who is not a surviving spouse) for 2018.

(4) **Kiddie Tax**. Under pre-Act law, the earned income of a child is taxed under the child's single individual rates, but unearned income of a child who is subject to the Kiddie Tax (generally children with unearned income exceeding $2,100 who are under age 18 and some children up to age 23 meeting certain requirements) is taxed at the parents' rates if those rates are higher than the child's rate. The Act continues but simplifies the Kiddie Tax by applying ordinary and capital gains rates applicable to trusts and estates, which often are higher than the parents' rates, to the unearned income of the child. This change does not affect the ability of the child to take advantage of the $200,000 threshold for protection from the 3.8% net investment income tax.

(5) **Child Tax Credit**. The Act increases the child tax credit from $1,000 for each qualifying child under age 17 to $2,000 (not indexed) and the phase-out would not begin until income exceeds $400,000 (not indexed) for married taxpayers filing jointly or $200,000 (not indexed) for other taxpayers. The Act also increases the refundable portion of the credit.

The Act also allows a $500 (not indexed) nonrefundable credit for qualifying dependents other than qualifying children.

No credit is allowed with respect to qualifying children unless the taxpayer provides the child's Social Security number.

Because of the substantial increase in the child tax credit, families with multiple children may be among the most likely to realize significant income tax decreases under the Act. The expanded child tax credit provision has a very large revenue impact–projected at $573.4 billion over ten years.

(6) **Charitable Deduction**. The Act continues to provide that charitable contributions are deductible, with an increased limitation on cash contributions – i.e., 60% of the "contribution base" (generally AGI with a few modifications), up from 50%. The 80% deduction for contributions made for university athletic seating rights is eliminated. The exception from the substantiation requirement if the donee organization files a return that contains the same required information is repealed, effective for contributions made in taxable years beginning after 2016.

(7) **Home Mortgage Interest Deduction**. Home mortgage interest for acquisition indebtedness of a residence that is incurred after December 15, 2017 is limited to the interest on $750,000 (down from $1 million) of debt. The $750,000 limitation is not indexed. Pre-Act rules apply to acquisition indebtedness incurred prior to that date, and to refinancings of those loans not exceeding the refinanced indebtedness. No deduction is allowed for interest on home equity indebtedness (regardless when incurred) for 2018-2025 (after which time the individual provisions sunset, as discussed in Item 2.e.21 below).

(8) **State and Local Taxes Deduction**. After considerable negotiation, the deduction for state and local income, sales, and property taxes (colloquially referred to as "SALT") not related to a trade or business or a §212 activity is retained but limited to $10,000 (not indexed) for joint filers and unmarried individuals and $5,000 (not indexed) for a married individual filing a separate return (now representing another "marriage penalty" provision in the Code). This limitation may be significant for taxpayers living in high income tax states, and can be a factor in deciding where to establish (or whether to change) one's domicile.

The $10,000 limit on SALT deductions has led some states to consider implementing laws providing relief from state income tax to the extent of contributions to a specified charitable fund, in hopes that the taxpayer could deduct the full charitable contribution without any $10,000 limitation. As an example, a taxpayer in Arizona may donate $500 to a tax-exempt private school in Arizona and receive a dollar-for-dollar reduction in state income tax liability (up to a maximum of $500) against the state income tax liability. While the $500 reduction of state income tax liability might be viewed as a quid pro quo that should reduce the charitable deduction, some authority exists for permitting the full charitable deduction in similar situations. *See* Chief Counsel Advice 201105010.

This limitation might lead to some taxpayers having residences owned by various trusts for various beneficiaries, each of which would have its own $10,000 limitation for the property tax deduction. See Item 2.e.(8) and Item 2.e.(20)(c) below.

The SALT $10,000 limitation does not apply to taxes paid "in carrying on a trade or business or an activity described in section 212" (i.e., investment activities), so should not apply to state and local taxes reported on Schedule C (for a trade or business) or Schedule E (net income from rents and royalties).

(9) **Miscellaneous Itemized Deductions Not Deductible.** The Act adds new §67(g) as follows:

> (g) SUSPENSION FOR TAXABLE YEARS 2018 THROUGH 2025.—Notwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.

Section 67(a) provides that "miscellaneous itemized deductions" (described in §67(b)) may be deducted only to the extent they exceed 2% of adjusted gross income (AGI). Miscellaneous itemized deductions are all itemized deductions *other than* those specifically listed in §67(b); the excepted items (which are still deductible) include deductions for payment of interest, taxes, charitable contributions by individuals or trusts and estates, medical expenses, and estate tax attributable to income in respect of a decedent (under §691(c)).

The effect is that the Act, in very few words, eliminates many itemized deductions for taxable years beginning in 2018-2025. The Joint Explanatory Statement summarizes the present law by listing a large number of deductions treated as miscellaneous itemized deductions, and concluding that "taxpayers may not claim the above-listed items" as deductions during the suspension years. (The listed expenses include tax preparation expenses.)

The disallowance of many deductions for individuals may have an impact on state income taxes as well, because many states base their income tax calculation on the federal taxable income.

See Item 2.e.(20)(d) below regarding the impact of this provision on the deductibility of the executor and trustee fees and other expenses of trusts and estates.

(10) **Pease Limitation Eliminated**. The Pease limitation (reducing most itemized deductions by 3% of the amount by which AGI exceeds a threshold amount [$313,800 in 2017 for married couples] but with a maximum reduction of 80%) is eliminated for 2018-2025. Eliminating the Pease limitation may have little impact for many taxpayers, however, in light of the elimination of most itemized deductions. Eliminating the Pease limitation can still be important for individual taxpayer itemizers who have substantial charitable or home mortgage interest deductions (as well as the SALT deduction, up to $10,000).

(11) **Qualified Business Income Deduction**. In connection with the decrease of the top corporate tax rate to 21%, a deduction is allowed for individual business owners of businesses operated in pass-through entities (sole proprietorships, partnerships, limited liability companies, or S corporations). The deduction under new §199A is included in the portions of the Act dealing with individuals, but the deduction is discussed in the Business Tax Matters section of this summary, below. The deduction will be a very significant deduction for some business owners.

(12) **Medical Expenses**. The Act retains the medical expense deduction and even expands the deduction for two years by reducing the threshold to 7.5% (rather than 10%) of AGI for 2017-2018.

(13) **Alimony; Repeal of §682**. Alimony payments will not be deductible and will not be income to the recipient. In addition, §682 is repealed; that section provided that if one spouse created a grantor trust for the benefit of the other spouse, following the divorce the trust income would not be taxed to the grantor-spouse under the grantor trust rules to the extent of any fiduciary accounting income that the donee-spouse is "entitled to receive." The repeal of §682 is particularly troublesome, in part because §672(e) treats a grantor as holding any power or interest held by an individual who was the spouse of the grantor at the time of the creation of such power or interest, so the ex-spouse's interest as a beneficiary will likely be sufficient to trigger grantor trust status under §677 even following the divorce.

The alimony and repeal of §682 provisions are effective for any divorce or separation instrument executed after December 31, 2018 and any divorce or separation instrument executed before that date but modified after that date if the modification expressly states that the amendments made by this section of the Act apply to such modification. This provision does not sunset after 2025.

This change will have a significant impact on the negotiation of divorce agreements. Many divorce agreements include agreements to pay alimony in order to take advantage of using the recipient spouse's lower income tax brackets. The inability to shift income tax responsibility for alimony payments or for the income of grantor trusts may have an impact on the negotiated amount of alimony. The Act may create an incentive for spouses who are contemplating divorce to complete the divorce before the end of 2018.

(14) **Moving Expenses**. The deduction for moving expenses incurred in connection with starting a new job at least 50 miles farther from the taxpayer's former residence than the former workplace and the exclusion from income of moving expense reimbursements are eliminated for 2018-2025, except for members of the Armed Forces in certain circumstances.

(15) **Alternative Minimum Tax**. The alternative minimum tax (AMT) is not eliminated for individuals, but the AMT exemption for individuals is increased from $78,750 to $109,400 (indexed) and the phase-out threshold is increased from $150,000 to $1,000,000 (indexed) for married taxpayers filing joint returns.

(16) **Recharacterizing Roth IRAs**. Contributions to Roth IRAs are non-deductible (i.e., are made from after-tax income), but qualified distributions from Roth IRAs are

not includible in the recipient's income. Traditional IRAs may be converted to Roth IRAs, and the amount converted is includible in the taxpayer's income as if a withdrawal had been made. Under pre-Act law, a Roth IRA that received a contribution or that resulted from a conversion of a traditional IRA could have been recharacterized as a traditional IRA before the due date for the individual's income tax return for that taxable year. For example, if assets in a Roth IRA decline in value after conversion from a traditional IRA, the Roth IRA could be recharacterized as a traditional IRA to avoid the income recognition from the conversion, and the recharacterized traditional IRA could again be converted to a Roth IRA at the lower values. The Act eliminates the recharacterization option for conversions (but not for contributions), effective for taxable years beginning after 2017 (and this provision does not sunset after 2025).

(17) **Expanded Application of 529 Accounts**.   For distributions after 2017, "qualified higher education expenses" will include tuition at public, private, or religious elementary or secondary schools, limited to $10,000 per student during any taxable year.

(18) **Life Settlements of Life Insurance Policies**. For viatification (life settlements) of life insurance policies, the Act provides that the taxpayer's basis in a life insurance policy is not reduced by the "cost of insurance" charges, reversing the IRS position announced in Rev. Rul. 2009-13. Reporting requirements are added for "reportable policy sales," and none of the transfer for value exceptions apply to such sales. These provisions do not sunset after 2025.

(19) **Eliminate Mandate for Health Insurance**. The Act eliminates the mandate for having qualifying health insurance beginning in 2019 (which is anticipated to save $318-$338 billion over 10 years because of reduced federal subsidies to low income persons who purchase coverage). The Congressional Budget Office and Joint Committee on Taxation project that this change will result in 13 million fewer people having health insurance by 2027 and will increase insurance premiums for many Americans by about 10%.

(20) **Provisions Impacting Trusts and Estates**.

(a) **Tax Provisions for Individuals Generally Apply to Trusts**. Section 641(b) provides that "[t]he taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part."

(b) **Personal Exemption**. In lieu of the deduction for personal exemptions, an estate is allowed a deduction of $600, a complex trust is allowed a deduction of $100, and a simple trust (required to distribute all of its income currently) is allowed a deduction of $300. An exception is made for a "qualified disability trust" which gets a deduction equal to the personal exemption of an individual. While the personal exemption for individuals is repealed, the Act adds new §642(b)(2)(C)(iii) to apply a deduction of $4,150 (indexed) for qualified disability trusts for years in which the personal exemption for individuals is zero (i.e., 2018-2025). The $600, $100, and $300 deduction amounts for estates and trusts other than qualified disability trusts are not changed by the Act.

(c) **State and Local Taxes.** The $10,000 limit on deducting state and local taxes under the Act applies to trusts (as made clear in footnote 171 of the Joint Explanatory Statement). This may create some incentive for creating multiple trusts, subject to the anti-abuse provisions for multiple trusts under §643(f), so that each separate trust would be entitled to its own $10,000 limit on the SALT deduction. Having different beneficiaries or other terms of the separate trusts would be important for avoiding §643(f). Section 643(f) applies for trusts having substantially the same grantors and primary beneficiaries if the principal purpose of the trusts is to avoid income tax, but it applies "under regulations prescribed by the Secretary" and no such regulations have ever been issued. However, other tax or nontax reasons may exist for having a single trust.

(d) **Executor or Trustee Fees and Other Miscellaneous Estate or Trust Expenses.** New §67(g) states that "[n]otwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026." Section 67(a) provides that "miscellaneous itemized deductions" (described in §67(b)) may be deducted but only to the extent they exceed 2% of adjusted gross income. Miscellaneous itemized deductions are all itemized deductions *other than* those specifically listed in §67(b), and executor and trustee fees are not listed in §67(b), so does new §67(g) preclude their deduction?

The answer is not clear. Executor and trustee fees and other miscellaneous estate/trust expenses are deductible under §67(e) to the extent that they satisfy the requirement of being expenses that "would not have been incurred if the property were not held in such trust or estate."

Section 67 does not authorize deductions but limits deductions that would otherwise be allowed under other Code sections. New §67(g) says that miscellaneous itemized deductions are not allowed "notwithstanding §67(a)," but makes no reference to §67(e).

The specific reference to §67(a) but not §67(e) leaves the possible implication that miscellaneous itemized deductions could be allowed under §67(e). Section 67(e)(1) states (independently of §67(a)) that miscellaneous itemized deductions "shall be treated as allowable" in calculating an estate/trust's AGI as long as the expenses are "paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate," and §67(e)(2) makes clear that §67 does not limit the deductions for estates or trusts under §§642(b), 651, or 661.

Various arguments have been suggested to support the continued deductibility of miscellaneous deductions for estates and trusts notwithstanding §67(g). One argument is that superseding §67(e) would lead to illogical results. To say that new §67(g) supersedes §67(e) would suggest that it overrides not just §67(e)(1) but also §67(e)(2), which addresses §§642(b) (the deduction in lieu of personal exemption), 651, and 661. That would result in the illogical conclusion that §642(b) is overridden although other provisions of the Act provide expanded relief under §642(b), and would also mean that trusts and estates get no distribution deductions (which would completely overturn the basic premise of the income taxation of trusts and estates).

Additionally, the Joint Explanatory Statement describes the addition of §67(g) as suspending "all miscellaneous itemized deductions that are subject to the two-percent floor under present law." Arguably, therefore, the intent was not to eliminate the deduction of items that were permitted under §67(e) because they are not "subject to the two-percent floor under present law."

Another argument suggested by Steve Gorin (St. Louis) is that because the deductions are allowable in determining AGI (i.e., they are "above the line" deductions), they are not "itemized deductions" at all (and therefore not miscellaneous itemized deductions) because of §63(d)'s definition of itemized deductions:

> Code §63(d) provides, "For purposes of this subtitle, the term 'itemized deductions' means the deductions allowable under this chapter other than (1) the deductions allowable in arriving at adjusted gross income, and (2) the deduction for personal exemptions provided by section 151." So Code §67(e)(1) recharacterizes those expenses as above-the-line and not being itemized deductions at all. Not being itemized deductions any more, they are not subject to Code §67(a). When Code §67(e) says "for purposes of this section," it is explaining that its recharacterization of expenses supersedes the definition in subsection (b) that otherwise would have applied to the expenses (described in Code §67(e)(1)) and that therefore these expenses are no longer subject to subsection (a).
>
> …
>
> Nothing [in the Act or the Joint Explanatory Statement] suggests that Code §67(e)(1) has been directly or indirectly repealed as well.

(e) **Excess Deductions or Losses at Termination of Estate or Trust**. Section 642(h)(1) provides that on the termination of an estate or trust, a net operating loss or capital loss carryover shall be allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust. Capital losses are not itemized deductions, so new §67(g) should not impact them.

On the other hand, §642(h)(2) states that on the termination of an estate or trust any deductions for the last taxable year of the estate or trust (other than the deduction in lieu of personal exemptions and other than the charitable deduction) in excess of gross income for the year shall be allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust. Those deductions are not mentioned in §67(b) and are miscellaneous itemized deductions, therefore their deduction is not allowed for 2018-2025 under new §67(g). Indeed the Joint Explanatory Statement specifically includes "[e]xcess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust" as one of the "above listed items" that cannot be claimed as a deduction under §67(g). The discussion about *estate/trust* deductions in paragraph d above does not apply, because these are deductions to the individual beneficiaries, not to the trust.

(f) **Alternative Minimum Tax**. The Act increases the AMT exemption for individuals, but not for trusts and estates. The exemption amounts for trusts and estates will likely be slightly lower than the previously announced amounts for 2018 because of the Act's requirements to use chained CPI indexing.

(g) **Section 691(c) Deduction for Estate Taxes Attributable to Income in Respect of a Decedent.** New §67(g) does not suspend the §691(c) deduction for estate tax attributable to income in respect of a decedent because the §691(c) deduction is one of the items listed in §67(b) as *not* being a miscellaneous itemized deduction "for purposes of this section," which would include new §67(g).

(h) **Electing Small Business Trusts**.

(1) **NRA as Permitted Potential Beneficiary**. The Act allows a nonresident alien (NRA) individual to be a potential current beneficiary of an electing small business trust (ESBT).

(2) **Charitable Deduction Allowed Under §170 Rather Than §642(c)**. The charitable contributions deduction for trusts is governed by §642(c) rather than §170, which governs the charitable deduction for individuals. Several restrictions that apply under §642(c), but not under §170, are that the distribution must be made from gross income and pursuant to the terms of the governing instrument (and the governing instrument requirement has been applied strictly). In addition, no carryover of excess contributions is allowed for trusts. The Act provides that the charitable contribution deduction of an ESBT is determined by rules applicable to individuals under §170, not the rules applicable to trusts under §642(c), effective for taxable years beginning after 2017. This will be favorable in various respects for charitable contributions made by the portion of an ESBT holding S corporation stock. Eliminating the gross income requirement means that a charitable deduction would be available for gifts of property, the same as for individuals. The governing instrument requirement will no longer apply. Excess charitable deductions can be carried forward for five years. Possible negative effects of applying §170 rather than §642(c) to ESBTs are that the percentage limitations (but also the carryforward provisions) applicable to individuals will apply to charitable contributions made by the portion of an ESBT holding S corporation stock, and the substantiation requirements that apply to individuals under §170 will also be applicable to ESBTs, effective for taxable years beginning after 2017.

(3) **No Sunset**. The changes described above for ESBTs are permanent and do not sunset after 2025.

(4) **Section 199A Deduction**. ESBTs appear to qualify for the §199A deduction, discussed in Item 2.e.(2) below.

(21) **Sunset after 2025** – Almost all of the individual income tax changes will expire after 2025. This includes (among the many individual tax changes) the deduction for

business income from pass-through entities, individual rate cuts, expanded child tax credit, expanded standard deduction, repeal of personal exemptions, and increases in the transfer tax exclusion amounts. A few (very few) of the individual income tax changes do not sunset after 2025, including the use of the chained CPI, which has the effect of moving taxpayers into higher brackets in future years as compared to the current indexing approach, alimony and §682 repeal, recharacterization of Roth IRA conversions, and the life insurance settlement provisions.

(22) **"Five Year Rule" On Mandatory Distributions From Qualified Plans and IRAs Not Included**. The Senate Finance Committee on September 21, 2016 *unanimously* approved the Retirement Enhancement and Savings Bill of 2016, which among other things would have required that distributions from qualified plans and IRAs be made within five years of the death of the participant, with limited exceptions (one being for a surviving spouse) to the extent all of an individual's plans exceed $450,000. Despite Congress's focus on finding revenue to offset the tax cuts in the Act, this provision is not included.

The issue will likely arise again at some point. For a further discussion of the provisions in that Retirement and Enhancement and Savings Bill of 2016, see Item 2.g of the Estate Planning Current Development and Hot Topics Summary (October 2017), found **here** and available at **www.Bessemer.com/Advisor**.

e. **Business Tax Matters**.

(1) **Corporate Tax Rate**. The top corporate tax rate is 21% under the Act, effective beginning in 2018. This reduced top income tax rate applies to any entities that are subject to income taxation under Subchapter C.

(2) **Qualified Business Income from Pass-Through Entities**. A complicated provision in new §199A provides tax-favored treatment of business income from pass-through entities (sole proprietorships, partnerships, limited liability companies, or S corporations) that are not subject to taxation under Subchapter C and that will be taxed at the individual tax rates of the owners, which could be as high as 37%. The tax advantage under §199A reduces the wide discrepancy (21% vs. 37%) in the top rates at which business income would be taxed, depending on whether the business is taxed as a corporation or as a pass-through entity. Very generally (but with various limitations and exceptions), the §199A deduction results in a top rate of 29.6% (as discussed below) for the taxation of business income from pass-through entities. The provision is in the Subtitle A of the Act addressing individual tax reform (in particular in Section 11011 of the Act), but is included in the business tax portion of this summary.

(a) **Overview of Deduction**. Way overly simplified –

(1) **20% Deduction; Wage Limitation**. The Act allows a deduction equal to 20% of qualified business income from pass-through entities, limited to 50% of the taxpayer's pro rata share of the total W-2 wages paid by the business (including wages paid to the taxpayer). The Joint Explanatory Statement explains that the W-2 wages limitation is meant to "deter high-income

taxpayers from attempting to convert wages or other compensation for personal services to income eligible for the 20-percent deduction." The 20% deduction results in an effective top rate of (1 – 0.20) x 37%, or 29.6%.

(2) **Qualified Business Income**. Qualified business income is generally the net amount of income, gain, deduction, and loss from an active trade or business within the United States, but not including certain types of investment income (capital gains, dividends or interest unless the interest is allocable to a trade or business), and not including reasonable compensation paid to the taxpayer, any guaranteed payment under §707(c), or payment to a partner for services under §707(a). A net loss from a particular business in one year carries over to the next taxable year as a loss for that business.

(3) **"Real Estate Exception" to Wages Limitation**. The wages limitation was relaxed in the Conference Agreement by adding that the wage limitation is the greater of (a) 50% of W-2 wages, or (b) the sum of 25% of W-2 wages plus 2.5% of the unadjusted basis, immediately after acquisition, of all tangible property subject to depreciation (which could be very beneficial to real estate companies).

(4) **Specified Service Companies**. The deduction does not apply for specified service businesses in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any business where the principal asset is the reputation or skill of one or more of its employees (by reference to §1202(e)(3)(A)), except for engineering or architecture. This provision decreases the incentive of specified service businesses to pay low compensation income for the service-provider employees and claim that most of the income from the business is qualified business income entitled to the 20% deduction.

(5) **Exceptions for Lower Income Taxpayers**. The 50% wage limitation (as modified by the "real estate" exception summarized above), and the specified service limitation do not apply if the taxpayer has taxable income below a threshold amount of $315,000 (indexed) for married individuals filing jointly and $157,500 (indexed) for other taxpayers, with a phase-out of the deduction for taxpayers over the next $100,000/50,000 of taxable income. Even though the specified service business limitation may not apply for a particular taxpayer whose income is below the threshold, reasonable compensation concepts still apply in determining what constitutes qualified business income.

(6) **REIT, Publicly Traded Partnership, Qualified Cooperative Dividends**. A straight 20% deduction generally applies to qualified REIT dividends, qualified publicly traded partnership income, and qualified cooperative dividends (subject to the overall limit described below of taxable income less net capital gains). In effect, the wage limitation does not apply to those types of income.

(7) **Trusts and Estates**. The deduction is available to non-corporate taxpayers, including trusts and estates. (The Senate version would not have made the deduction available to trusts and estates.) In applying the wage limitation, W-2 income from entities owned by trusts and estates is apportioned between beneficiaries and the fiduciary under §199(d)(1)(B)(i), which has the effect of applying the rather complicated rules in Reg. §1.199-9(d)-(e).

(8) **Deduction Cannot Exceed Taxable Income Less Net Capital Gain**. The deduction cannot exceed taxable income reduced by the taxpayer's net capital gain for the year. In effect, the 20% deduction cannot exceed the taxpayer's ordinary and qualified dividend income.

(9) **No Reduction of AGI; Deduction Available to Non-Itemizers**. The deduction reduces taxable income, but not AGI (so the deduction does not affect limitations throughout the Code based on AGI). The deduction is available to both itemizers and non-itemizers. (In other words, the deduction is available in addition to the standard deduction.)

(b) **A Little More Detail**. The details get ***much*** **more complicated**. Section 199A(a) describes generally the amount of the deduction, subject to a variety of definitions, modifications, special rules, and anti-abuse rules described in §199A(b)-(h). The Conference Agreement summarizes the deduction amount as follows:

The taxpayer's deduction for qualified business income for the taxable year is equal to the sum of (a) the lesser of the combined qualified business income amount for the taxable year or an amount equal to 20 percent of the excess of taxpayer's taxable income over any net capital gain and qualified cooperative dividends, plus (b) the lesser of 20 percent of qualified cooperative dividends and taxable income (reduced by net capital gain). This sum may not exceed the taxpayer's taxable income for the taxable year (reduced by net capital gain). Under the provision, the 20-percent deduction with respect to qualified cooperative dividends is limited to taxable income (reduced by net capital gain) for the year. The combined qualified business income amount for the taxable year is the sum of the deductible amounts determined for each qualified trade or business carried on by the taxpayer and 20 percent of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income. The deductible amount for each qualified trade or business is the lesser of (a) 20 percent of the taxpayer's qualified business income with respect to the trade or business, or (b) the greater of 50 percent of the W-2 wages with respect to the trade or business or the sum of 20 percent of the W-2 wages with respect to the trade or business and 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

Got all that? (And that is a VERY simplified summary of the actual statute.) The headings of the subparagraphs of §199A provide an indication of the many detailed provisions in the statute: (b) Combined Qualified Business Income Amount; (c) Qualified Business Income, (d) Qualified Trade or Business; (e) Other Definitions; (f) Special Rules; (g) Deduction Allowed to Specified Agricultural or Horticultural Cooperatives; and (h) Anti-Abuse Rules. For a more detailed description of the detailed operation of §199A(a) with examples, see Samuel Donaldson, *Understanding the Tax Cuts and Jobs Act* (2018); Alan Gassman & Brandon Ketron, *Dymistifying the New Section 199A Deduction for Pass-Through Entities,* LEIMBERG INCOME TAX PLANNING NEWSLETTER #125 (January 4, 2018); Leimberg, Geeraerts, & Magner, *Tax Cuts and Jobs Act of 2017 – What Advisors Need to Know to Better Inform Their Clients*, LEIMBERG ESTATE PLANNING NEWSLETTER #2609 (December 16, 2017); Tony Netti, Tax Geek Tuesday: Making Sense of the New '20% Qualified Business Income Deduction,' Forbes (Dec. 6, 2017); **https://www.forbes.com/sites/anthonynitti/2017/12/26/tax-geek-tuesday-making-sense-of-the-new-20-qualified-business-income-deduction/#775b9e8e44fd**.

(c) **ESBTs Qualify for §199A Deduction**. The statute and legislative history do not specifically address the availability of the §199A deduction for ESBTs, but they presumably qualify for the deduction. Section 641(c) describes the manner in which the taxable income and the tax is determined for ESBTs, and §641(c)(2)(C) states that only certain items of income, loss, deduction, or credit may be considered in determined the tax for ESBTs, but the few allowed items include "[t]he items required to be taken into account under section 1366." Section 1366 describes the pass-through of items to S corporation shareholders, which would include the pass-through of business income that would be reported on the Schedule K-1 from the S corporation.

(d) **Revenue Impact**. The Joint Committee on Taxation projects that the deduction for business income from pass-through entities will cost $414.4 billion over ten years, which suggests that the provision will present substantial planning and tax savings opportunities for taxpayers who can take advantage of the deduction.

(3) **Increased Section 179 Expensing**. Under pre-Act law, taxpayers could generally deduct the cost of depreciable tangible personal property and certain real property purchased for use in a trade or business, but only up to $500,000 (indexed) reduced by the cost of qualifying property placed in service during the year in excess of $2 million (indexed). The balance of the cost is depreciated over an applicable period of years. The Act increases the allowed expensing levels to $1 million, and the phase-out threshold amount is increased to $2.5 million.

(4) **100% Expensing for Qualifying Business Assets**. Under pre-Act law, an additional first-year depreciation deduction is allowed equal to 50% of the adjusted basis of qualified property placed in service before 2020 (subject to various qualifications). The Act allows 100% expensing for qualified property (generally, depreciable assets other than buildings) that is acquired and placed in service after September 27, 2017 and before 2023 (before 2024 for "longer production period"

property and certain aircraft), and extends the expensing to the acquisition of used as well as new property. A 20% per year phase-down of full expensing will apply for property placed in service after 2022 and before 2027.

(5) **Interest Deductions for Businesses**. Interest deductions for businesses with average annual gross receipts over $25 million for the three prior years generally are limited under the Act to 30% of the corporation's adjusted taxable income computed without regard to depreciation, amortization, or depletion deductions for taxable years beginning after 2017 and before 2022, and for later taxable years computed without regard to depreciation, amortization, depletion, or the deduction under §199A for qualified business income of a pass-through entity. Disallowed interest can be carried forward indefinitely. Various complicated detailed rules and exceptions apply in determining the interest deduction limitation, but the limitation will be significant.

(6) **Corporate Alternative Minimum Tax Repealed**. The corporate alternative minimum tax is repealed. A planning implication is that one of the possible disadvantages of having corporate owned life insurance to fund an entity-purchase buy sell agreement will be removed, which could impact the decision of whether to use an entity-purchase or cross-purchase arrangement for corporate buy-sell agreements.

(7) **Like-Kind Exchanges Limited to Real Property**. Like-kind exchanges are permitted for property held for use in a trade or business or for investment. Under pre-Act law, like-kind exchanges are permitted for real or personal property. Under the Act, like-kind treatment will be limited to real property.

(8) **Entertainment Expenses**. No deduction will be allowed for expenses of a trade or business related to entertainment, amusement, or recreation activities or for membership dues to any club organized for business, pleasure, recreation, or other social purposes. The 50% limitation on deductions continues to apply for meals associated with operating the trade or business. The Joint Explanatory Statement gives this example: "(e.g., meals consumed by employees on work travel)."

(9) **Net Operating Losses**. Net operating losses (NOLs) are deductible only up to 80% of taxable income (determined without regard to the deduction). Under pre-Act law, they were fully deductible. NOLs cannot be carried back to prior years, as was permitted under pre-Act law, but indefinite carryforwards will continue to be allowed.

(10) **Qualified Stock Options**. Employees who receive stock options or restricted stock for the performance of services may defer recognition of income for up to five years upon exercise of the options (or earlier when the qualified stock becomes transferable or readily tradable on an established securities market). The special deferral provision does not apply to a 1% owner of a corporation, a CEO or CFO, any of the four highest compensated officers for any of the 10 preceding years, and family members of a 1% owner, CEO, or CFO.

(11) **Carried Interest**. A 3-year holding period will apply in order for certain partnership interests received in connection with the performance of services to be taxed as long-term capital gain. The 3-year holding period requirement applies notwithstanding the rules of §83 or whether a §83(b) election was made.

(12) **Deemed Partnership Termination.** A sale of 50% or more of the capital and profits of a partnership will no longer result in a technical termination of the partnership.

f. **Tax-Exempt Organizations**.

(1) **UBTI Determined Separately For Each Activity**. New §512(a)(6) provides that the unrelated business taxable income (including for purposes of determining any NOL deduction) is determined separately for each trade or business activity. A deduction from one activity cannot offset the income from another activity in determining the organization's UBTI, but a loss from an activity in one year can offset the income from the same activity in another year. Under a special transition rule, NOLs that arise in taxable years beginning before 2018 that are carried over to a later year are not subject to this new limitation.

(1) **Excise Tax for Certain Private Colleges and Universities**. A 1.4% of net investment income excise tax applies to private colleges and universities that have more than 500 students, assets of at least $500,000 per full-time student, and 50% of tuition paying students located in the United States. This provision will apply to only a very limited number of private colleges and universities.

3. Estate Planning Considerations In Light of New Legislation and Inherent Uncertainty Arising From 2026 Sunset

a. **Déjà Vu on Steroids.** Planning alternatives that were considered in 2013 following the passage of ATRA, when the gift tax exclusion amount increased from $1 million to $5 million have resurfaced in light of the doubling of the gift tax exclusion. Indeed many of the detailed planning issues summarized in the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.Bessemer.com** are highly relevant for 2018.

b. **Paradigm Shift**. The increased $10 million (indexed) estate and gift tax basic exclusion amount for every individual means that estate and gift taxes are irrelevant for most clients. Concepts that have been central to the thought processes of estate planning professionals for their entire careers are no longer relevant for most clients – even for "moderately wealthy" clients (with assets of over several million dollars). For example, structuring trusts to qualify for the gift tax annual exclusion may be unnecessary for many clients who will *never* have any gift or estate tax concerns (though professional advisers must still advise them of the requirement to file gift tax returns reporting any taxable gifts that do not qualify for the annual exclusion). Structuring testamentary charitable trusts to qualify for the estate tax charitable deduction under §2055 will no longer be important for many clients. It is hard for "old dogs to learn new tricks," and planners will constantly have to be sensitive to the major paradigm shift resulting from the Act.

c. **Small Percentage of Population Subject to Transfer Taxes**. Only about 1,800 of 2018 decedents will have to pay estate tax in 2018 (with an estate tax exclusion amount of about $11.2 million), down from about 5,000 decedents in 2017 (with an estate tax exclusion amount of $5.49 million). See Heather Long, *3,200 Wealthy Individuals*

Wouldn't Pay Estate Tax Next Year Under GOP Plan, Washington Post (Nov. 5, 2017) (based on analysis of Joint Committee on Taxation). The $10 million (indexed) gift tax exclusion amount also means that many individuals have no concern with lifetime gifts ever resulting in the payment of federal gift taxes. Wealthy clients still exist, though, and the wealthy are getting wealthier.

d. **Non-Resident Alien Individuals**. The exclusion amount has NOT increased for non-resident alien individuals (NRAs). The exclusion amount remains at $60,000 (*see* §2102(b) (unified credit of $13,000, which is the amount of tax on a $60,000 estate)). Do not be lulled into thinking that federal estate tax concerns have vanished for NRAs because of the large increase in the exclusion amount that applies to citizens or residents of the United States.

e. **Cannot Ignore GST Tax**. Even low to moderate-wealth individuals cannot ignore the GST tax. Without proper allocation of the GST exemption (also $10 million indexed), trusts created by clients generally will be subject to the GST tax at the death of the beneficiary unless the trust assets are included in the beneficiary's gross estate. Sometimes the allocation will occur by automatic allocation, but the planner must be sure that proper GST exemption allocation is made to long-term trusts (unless the trust assets will be included in the beneficiary's gross estate) even though the purpose of the trusts is not to save transfer taxes. The planner might specifically structure trusts that will not qualify for automatic allocation so that the assets will be included in a beneficiary's gross estate if the beneficiary dies before the termination of the trust, if the planner anticipates that the beneficiary will have sufficient estate tax exclusion amount to eliminate estate tax for the beneficiary even with the trust assets included in the estate (and the inclusion of those assets would also be helpful for basis adjustment purposes, as discussed in Item 3.i.(2) below).

   Grantors who have previously created irrevocable trusts that are not fully GST-exempt may want to allocate some of the increased GST exemption amount to the trust. Presumably this is permitted, but the increased estate and gift tax exclusion amount (which is also the GST exemption amount under §2631(c)) applies to "estates of decedents dying and gifts made after December 31, 2017," and the mere allocation of GST exemption to an existing trust is neither of those things.

f. **Review Formula Clauses.** Review formula clauses in existing documents. For example, a classic bequest to a credit shelter trust of the maximum amount possible without incurring estate taxes may become a bequest of the entire estate if the decedent's estate is less than the $10 million (indexed) basic exclusion amount. Confirm that is the client's intent. Having all of the estate pass to a credit shelter trust may also generate state estate taxes at the first spouse's death, as discussed in Item 3.g.(10) below. Planners may want to send letters to clients warning them that plans should be reviewed in light of the major impact that the substantial increase in the transfer tax exclusion amounts can have on estate plans.

g. **Testamentary Planning**. What testamentary planning approaches are preferred for couples with combined assets well under the approximately $22 million estate tax exclusion amounts available to the spouses?

As an overview of general planning themes depending on the size of the estate of a married couple:

(1) Couples with assets under $5.5 million – address whether assets will be left outright to the surviving spouse or in trust, and cause estate inclusion at the surviving spouse's subsequent death to receive a basis adjustment;

(2) Couples with assets over $5.5 million but less than $11 million – make use of the first decedent-spouse's exclusion amount with an outright gift with disclaimer planning or a QTIPable trust approach, creating flexibility through the manner in which the portability election is made (the portability election could create the possibility of using both spouses' exclusion amounts but allowing a basis adjustment of all of the estate assets at the second spouse's death); and

(3) Couples with assets over $11 million – same as category 2 but also consider gifts using some of the increased gift exclusion amount to save estate tax in case the exclusion amount is subsequently reduced back to $5.5 million and consider making transfers in a way that one of both spouses have potential access to some of the transferred assets for clients making large transfers.

These themes are addressed in more detail below. The alternatives begin with the simplest approaches, from a client perspective, but *not necessarily the preferred approaches*.

(1) **Outright-to-Spouse**. For clients who want simplicity and do not want to take advantage of the opportunities available with trust planning, the first decedent-spouse's assets could be left outright to the surviving spouse at the first spouse's death. Before employing this "maximum simplicity" approach, the planner should make sure that the client is aware of important planning opportunities that will be lost by not using trust protections for the surviving spouse. (The outright-to-spouse plan can also be disadvantageous in states with state estate taxes with exemptions low enough that the state estate tax might apply at the second spouse's death.)

(2) **Outright Bequest with Disclaimer to Trust**. The first decedent-spouse's assets could be left outright to the surviving spouse with a disclaimer provision causing the disclaimed assets to pass into a trust with the spouse (and perhaps others) as discretionary beneficiaries.

Several significant disadvantages may result from relying on the disclaimer approach. The most important is that the spouse may refuse to disclaim assets (or may be incompetent or may die before disclaiming), even though a disclaimer would be appropriate based on the tax situation. Another significant disadvantage to the disclaimer approach is that the surviving spouse cannot retain a nontaxable power of appointment over disclaimed assets. Reg. §25.2518-2(e)(2) & §25.2518-2(e)(5)(Ex. 5). However, a family member other than the surviving spouse-disclaimant (such as the spouse's brother or sister) could have a power of appointment that could be exercised at the spouse's death (or earlier if that is desired). In addition, the risk exists that the surviving spouse inadvertently accepts benefits, making a disclaimer impossible. Also, under the laws of some states, disclaimers may not be recognized for fraudulent transfer purposes with respect to the disclaimant's creditors (*e.g.*, Fl. Stat. §739.402(d)) and will be treated as disallowed transfers for Medicaid qualification purposes.

In states with a state estate tax, the surviving spouse could disclaim an amount that would not be subject to state estate tax at the first decedent-spouse's death. This decision may be made in a more granular manner by disclaiming assets that either will be held for a very long time period after the surviving spouse's life expectancy, or that are not likely to have significant appreciation potential (again keeping in mind that the income tax cost of not getting a basis step-up at the second spouse's death may outweigh the potential state estate tax).

(3) **Make Clients Aware of Trust Advantages**. Planners should make sure that clients are aware of various advantages of trusts even if the client has no federal transfer tax concerns. Potential advantages that will be important to some clients are opportunities to provide for appropriate management of assets, to place appropriate limitations on how assets can be used for beneficiaries, to allow the settlor to lock-in who will receive trust assets at the termination of the trust, to protect trust assets from claims of the beneficiaries' creditors, and to protect trust assets from claims of divorcing spouses or ex-spouses of beneficiaries. In addition, trusts may result in significant state transfer tax or state income tax savings.

Trust structuring should incorporate planning for flexible provisions to react to future conditions. Powers of appointment are becoming increasingly popular for various reasons in facilitating future flexibility.

(4) **Direct Bequest to Discretionary Trust For Spouse (And Perhaps Others) For Combined Estate Under $5 Million**. If the surviving spouse wants to take advantage of opportunities available with trusts, the first decedent-spouse's assets might be left directly to a trust permitting discretionary distributions to the surviving spouse (and perhaps other beneficiaries, as well). If the combined estate is under $5 million, so that no estate tax will result at the second spouse's death even if the second spouse dies after the increased estate tax basic exclusion amount has sunset back to $5 million (indexed), the trust could be designed to include any provisions desired by the clients, without the necessity of assuring that the trust qualifies for the estate tax marital deduction. A method for causing estate tax inclusion at the second spouse's death may be important to achieve a basis adjustment for the trust assets at the second spouse's death. (See Item 3.i.(2) below.)

(5) **Taking Advantage of First Decedent-Spouse's Exclusion Amount For Combined Estate Over $5 Million**. For the couple with over $5 million, being able to make use of the first decedent-spouse's estate exclusion may be important (if the second spouse dies after the time that the exclusion has declined back to $5 million (indexed)). That can be accomplished either by leaving assets into a trust that can act as a traditional credit shelter trust or by making the portability election following the first spouse's death. If the portability approach is used, the assets should pass in a manner that qualifies for the marital deduction, or else little DSUE may be available for the surviving spouse even if the portability election is made.

(6) **Increased Importance of Portability**. If the first spouse dies before 2026 while the estate tax basic exclusion amount is still $10 million (indexed), making the portability election should leave the surviving spouse with a DSUE of that full amount even if the basic exclusion amount later decreases in 2026. *See* Reg. §20.2010-2(c) (describing computation of DSUE amount).

Unless strong reasons exist to use credit shelter trusts in $10 million and under estates, relying on portability to take advantage of the first spouse's estate exclusion amount is increasingly helpful. The decision of whether to create a bypass trust following the first spouse's death can be delayed until after the first spouse has died using a disclaimer approach (Item 3.g.(2) above) or using a QTIPable trust (Item 3.g.(7) below), so that the tax law situation at that time can be considered (*e.g.*, whether the exclusion amount has returned to or is still likely to return to $5 million (indexed) in 2026).

A tax advantage of relying on portability rather than creating a bypass trust is that the surviving spouse has both spouses' exclusions to cover any estate taxes that might apply, but a basis step-up is achieved at both spouses' deaths.

Some of the factors for favoring the creation of a credit shelter trust at the first spouse's death include if there is (i) a likelihood or significant possibility of substantial appreciation of estate assets after the first spouse's death and the federal estate tax might apply to the surviving spouse's estate, (ii) a state estate tax, (iii) a younger client scenario (in which remarriage of the surviving spouse is likely), and (iv) a situation in which the couple wants to use trusts after the first spouse's death and wants to have both the surviving spouse and descendants as discretionary beneficiaries of the trust (although the surviving spouse may be able to receive trust distributions from a QTIP trust and make gifts to younger family members as desired in light of the increase gift tax exclusion amount). The credit shelter trust may also be advantageous for various reasons in blended family situations, as discussed in Item 8.d the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.Bessemer.com/Advisor**.

If the QTIP approach is used in connection with portability, in light of the wide ranging factors that must be considered and the inherent uncertainties involved with the portability decision, documents should provide broad exculpation to the fiduciary who must make the QTIP election.

(7) **Flexible QTIP Trust Approach**. A favored approach of many planners for testamentary planning will be the use of QTIP trusts, and the approach can be used for any size of estate if the clients want to use trust planning after the first spouse's death. [or if the transfer tax does not apply], which affords great flexibility). QTIP planning could use a single QTIP plan, or multiple QTIP trusts (for example, if a state estate tax applies with an exemption different than the federal estate tax exclusion amount, as discussed in Item 3.g.(10) below). An advantage of the single QTIP drafting approach is that the client (hopefully) can understand it, just realizing that it leaves a great deal of flexibility after the first spouse has died.

Portability would be used if a full QTIP election is made (and the first deceased spouse's GST exemption could be used by making a reverse QTIP election under §2652(a)(3)), and a bypass trust approach would be used if a partial QTIP election is made.

The trust could include a Clayton provision allowing more flexible terms if the QTIP election is not made, as discussed in the "Flexibilities" discussion below. Alternatively, the unelected QTIP trust could remain as a single-beneficiary mandatory income trust for the spouse. The amount of income paid to the spouse could be managed by the asset selection for the trust.

Estates under $5 Million. The approach could be used for combined estates under $5 million as a way of creating a trust that would be entitled to a basis adjustment at the surviving spouse's subsequent death–but an estate tax return would have to be filed following the first spouse's death to make the QTIP election, as discussed immediately below.

For estates that are small enough that an estate tax return would not be required at the first spouse's death, a disadvantage of the QTIP trust approach is that an estate tax return would have to be filed at the first spouse's death to make the QTIP election. Perhaps the trust could build in the possibility of causing the surviving spouse to have a testamentary general power of appointment at the surviving spouse's subsequent death, or to give the spouse a testamentary nontaxable power of appointment that could be exercised in a manner to trigger the Delaware tax trap, so the option would exist to avoid filing an estate tax return following the first spouse's death to make the QTIP election. In that case, while a basis adjustment would not apply at the second spouse's death because the trust is a QTIP trust (see §1014(b)(10)), it would apply for other reasons.

Estates over $5 Million. This approach could also be helpful for combined estates in the $5-$10 million range because qualifying for the marital deduction is important for those estates, in case the surviving spouse dies after the basic exclusion amount has reverted to $5 million (indexed).

Flexibilities of QTIPable Trust Approach. Even though the QTIP approach may seem more complicated to clients, in many ways, the QTIPable trust approach affords greater flexibilities.

- The executor has up to 15 months to decide whether to make the QTIP election and over what portion of the trust.
- The QTIP election could be made by a formula, thus providing a "savings clause" to assure that no estate tax would be paid at the first spouse's death (if his or her assets are over the new $10 million basic exclusion amount – or $5 million exclusion amount after the increased exclusion amount has sunset).
- If the QTIP election is made, the executor could make the "reverse-QTIP" election and allocate the decedent's GST exemption to the trust.
- If the state recognizes a "state only QTIP election," having assets in the QTIP trust may make the planning easier to fully utilize the first spouse's exclusion amount without paying any state estate taxes at the first spouse's death.
- Any unelected portion could pass to a standard bypass trust under a "Clayton" provision. Some planners believe that the surviving spouse should not be the executor making the QTIP election if there is a Clayton provision. The IRS might argue that if

the spouse makes the election, the spouse makes a gift of some or all of the assets that would have been in the QTIP trust. Commentators generally believe that there *should* be no gift tax consequences; this should be no different than other post-death tax elections (such as where to deduct administrative expenses) that have a direct impact on the amount of assets that pass to the credit shelter trust and to the surviving spouse (or QTIP trust). However, if the surviving spouse is the executor making the Clayton election, uncertainty would exist for years concerning whether a gift results and whether that causes §2036 inclusion issues for some portion of the credit shelter trust. But keep in mind the paradigm shift resulting from the huge $10 million exclusion amount. Many clients will have absolutely no risk of owing gift tax and may be unconcerned about potential gift risks of having the surviving spouse serve as the executor with a Clayton provision. A disadvantage of including a Clayton provision is that leaving the unelected portion in a trust with "QTIPable terms" (including a mandatory income interest for spouse as the exclusive beneficiary) would facilitate getting a "previously taxed property credit" under §2013 if the surviving spouse were to die shortly after the first spouse to die if the estate is large enough to have estate tax concerns. But many clients like being able to make transfers to children and the use distributions to the children for income-shifting purposes.

- The surviving spouse can have a testamentary nontaxable power of appointment over the assets in the QTIP trust (or the Clayton bypass trust).

(8) **QTIPable Trust With Delayed Power of Withdrawal**. If the clients want to have the flexibilities afforded by using a QTIP trust (*e.g*,, to have 15 months to decide what QTIP election to make, to make a formula QTIP election, etc.) but still want the spouse to have an unlimited withdrawal power, consider creating a standard QTIP trust but including a delayed withdrawal power. The trust is a general power of appointment trust qualifying for the marital deduction only if the surviving spouse's power of appointment exists immediately following the decedent's death. Reg. §20.2056-5(a)(4) ("must be exercisable in all events") & §20.2056-5(g)(1). For example, provide that the power of withdrawal arises sometime after estate tax filing date. Any limitations desired on the amount of the withdrawal right could be added (*e.g.,* up to 20% each year). Professor Jeff Pennell suggests that this perhaps should be the default approach for QTIP trusts, to be removed if the clients don't want the provision. (Jeff observes that most attorneys trust their own spouses after they are dead but think their clients do not trust their spouses.)

(9) **Creative Flexible Approaches Using Both Disclaimers and QTIP Trusts**. For a discussion of creative flexible approaches using both disclaimers and QTIP trusts, see Item 5.i of the Estate Planning: Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

(10) **State Estate Tax Planning Issues**. For clients that may be subject to state estate taxes, various issues must be considered in addition to the planning considerations described above.

- **State Exemption Amounts**. Seventeen states plus the District of Columbia have a state estate or inheritance tax. Various states are scheduled to adjust their state exemptions to the amount of the federal estate tax exclusion amount (Hawaii, Maine, and Washington, D.C. in 2018, Maryland in 2019, and Connecticut in 2020).

New York will move its exemption amount to $5 million (indexed) in 2019 (to match what the federal basic exclusion amount would have been under pre-Act law). States may not have contemplated an $11.2 million basic exclusion amount, however, in adopting those provisions, and some states may back off from increasing their state exemptions to the federal basic exclusion amount. *See* Ashlea Ebeling, *Where Not to Die in 2018*, Forbes (Dec. 21, 2017). When the federal exclusion amount reverts back to $5 million (indexed) after 2025, those state exemptions would adjust back to that amount as well.

- **Formula State Exemption Bypass Trust, Balance Outright to Spouse**. Because disclaimers sometimes don't happen as a practical matter, the clients may want to mandate that the bypass trust will be funded with the state exemption amount at the first spouse's death.
- **QTIP Trust Planning**. For clients subject to a state estate tax, flexible QTIP trust planning could result in (i) a "standard" QTIP trust for the excess over the federal basic exclusion amount, (ii) a QTIP trust effective only for state purposes (sometimes referred to as a "gap trust") for the amount in excess of the state exemption amount but less than the federal exclusion amount if the state allows a "state-only QTIP election," and (iii) a Clayton QTIP that has expanded into broader terms for up to the state exemption amount. This has the advantage of effectively having a federal bypass trust for an amount up to the full federal exclusion amount, but there is an obvious loss of distribution flexibility since all of the net income of a QTIP trust must be distributed annually to the surviving spouse, although the amount of net income that must be distributed could be managed, to a large degree, by the asset selection for the trust.
- **Formula State Exemption Bypass Trust, Balance to QTIP Trust**. Some states (like New York and New Jersey) provide that the federal QTIP election (or nonelection) is binding for state estate tax purposes as well. Leaving the balance above the state exemption amount to a QTIP trust would have the advantage of using trust planning for non-tax purposes for all of the estate at the first spouse's death.

h. **Emphasis on Flexibility.** In light of the remaining inherent uncertainty regarding whether the basic exclusion amount will be reduced back to $5 million (indexed) after 2025, building in flexibility to trust arrangements will be important, particularly for estates in the $5-$22 million range. Provisions included in trusts to avoid estate taxes may be unnecessary (and not desirable) for settlors or beneficiaries who have no estate tax concerns. Some of the ways of adding considerable flexibility are:

- using nontaxable powers of appointment;
- providing broad distribution standards by independent trustees;
- granting substitution powers to the settlor; and
- providing special modification powers to trust protectors (see Item 3(h)(8)-(11) of the Current Developments and Hot Topics Summary (November 2017) found **here** and

available at **www.Bessemer.com/advisor** for a more detailed discussion of powers and limitations that can be added for trust protectors to provide flexibility).

i. **Basis Adjustment Planning**. Planning to leave open the flexibility to cause trust assets to be included in the gross estate of a trust beneficiary if the beneficiary has excess estate exclusion will continue to be important to permit a basis adjustment at the beneficiary's death without generating any added estate tax. Indeed, incorporating planning for the flexibility to cause estate inclusion is more important than estate tax planning for most clients because most clients will not owe estate tax.

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

Does this work? Might the settlor be treated as having such a power even if never granted? The key issue is whether the decedent would be treated as having retained a §2036(a)(2) power to designate persons who could enjoy the property. No prearranged understanding should exist for the grant of such a power to defend against an argument that the decedent indirectly retained the power so that §2036(a)(2) could apply (because that section requires that the power be retained by the decedent at the time of the transfer). Reg. §20.2036-1(b)(3) provides that §2036 applies even if a power is merely exercisable in conjunction with other persons (whether or not adverse) and regardless of whether the exercise of the power was subject to a contingency beyond the decedent's control which did not occur before his death. That arguably would apply to the permitted grant to the settlor of a limited power of appointment even if it was never actually granted.

That same provision is not included in the regulations under §2038. See Reg. §20.2038-1(b) ("However, section 2038 is not applicable to a power the exercise of which was subject to a contingency beyond the decedent's control which did not occur before his death… See, however, section 2036(a)(2) for the inclusion of property in the decedent's gross estate on account of such a power.")

The court in *Estate of Skifter v. Commissione*r, 468 F.2d 699 (2d Cir. 1972), addressed a fact scenario in which the decedent had transferred a life insurance policy on his life to his wife who years later left the policy under her will to a trust for her daughter with the decedent as the trustee. The analysis analogized §2042 to §§2036 and 2038, and reasoned, in dictum, that §2036 would not apply because the power over the policy was not "retained by the grantor … when he transferred it to another" (without addressing the potential application of Reg. §20.2036-1(b)(3)). The court reasoned that §2038 would not apply to a power conferred on the decedent "by someone else long after he had divested himself of all interest in the property subject to the power," but suggested that §2038 would apply if the power were actually granted to the decedent and if the grant was pursuant to authority "that the decedent created at the time of transfer in someone else and that later devolved upon him before his death." If the grantor authorized a third party to grant a limited power of appointment to the grantor, and the third party actually granted that power to the grantor, then §2038 would apply under this analysis.

Whether the settlor will be treated as having the power causing inclusion in the gross estate even if the limited power of appointment is never actually granted to the settlor by the third party is not clear. The regulation under §2036 is very broad and potentially applies to the situation, and the discussion in *Skifter* is dictum.

(2) **Basis Adjustment for Beneficiary.** Possible strategies to allow a basis adjustment at a trust beneficiary's death include planning for the flexibility:

- to make distributions to the beneficiary (either pursuant to a wide discretionary distribution standard or under the exercise of a non-fiduciary nontaxable power of appointment);
- to have someone grant a general power of appointment to the beneficiary (that possibly could be exercisable only with the consent of some other non-adverse party (but not the grantor); consider using broad exculpatory language for the person who can grant the power of appointment and consider providing that the powerholder has no duty to monitor whether a general power should be granted or possibly provide that the powerholder has no authority to grant a general power until requested by a family member to consider exercising his or her discretion to grant a general power); but query whether the grant of a general power of appointment by a third party is treated as the beneficiary holding a general power of appointment with the consent of a non-adverse party, which would treat the beneficiary as having a general power of appointment whether or not the third party actually grants it?– Stated differently, if the power is never granted to the beneficiary, is it treated as a power exercisable upon the occurrence of an event which never happened and thus not a general power of appointment under Reg. §20.2041-3(b), or is it a power exercisable "in conjunction with another person," making it a general power under §2041(b)(1)(C) even though never granted?;
- to use a formula general power of appointment (see Item 10.m of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor)**;
- to the extent that general powers of appointment are used for basis adjustment purposes, bear in mind that the existence of the general power may have creditor effects, but the actual exercise of a testamentary general power of appointment may be more likely to subject the assets to the decedent-beneficiary's creditors than if the general power is not exercised (see Item 10.m of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor)**; or
- to trigger the Delaware tax trap by the exercise of a nontaxable power of appointment to appoint the assets into a trust of which a beneficiary has a presently exercisable general power of appointment.

See Item 14 of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor** for a more detailed discussion of these strategies. The 2017 Heckerling materials regarding portability by Lester Law and Howard Zaritsky have outstanding forms for all of these alternatives (including formula general powers of appointment and exercising the Delaware tax trap).

(3) **Upstream Gifts.** Many parents of clients (or other individuals) will have no federal estate tax concerns, even if the parents live past 2025 when the exclusion amount returns to $5 million (indexed)**.** Gifts may be made to individuals who have no estate tax concerns in hopes of getting a basis increase at the individual's death, and taking steps to avoid §1014(e) in case the donor should die within one year of the gift. See Item 3.j.(8) below.

j. **Transfer and Freeze Planning**. Transfer and freeze planning can (i) assist in shifting wealth to save estate tax for clients with assets in excess of the basic exclusion amount, (ii) provide creditor protection planning, (iii) assist in moving assets downstream during life, which is becoming more important as people have longer life expectancies and inheritances are long-delayed, and (iv) provide income shifting by transferring wealth to family members who may be in lower income tax brackets. The most obvious non-tax advantage of making gifts is to allow donees to enjoy the gift assets currently.

(1) **Window of Opportunity**. The gift tax exclusion amount will sunset back to about $5.5 million in 2026 (unless changed by Congress prior to 2026). Gifts making use of the doubled gift tax exclusion amount are available for eight years through 2025.

Gifts utilizing the $11 million exclusion amount can reduce federal estate tax if the donor dies after the basic exclusion amount has been reduced to $5 million (indexed), assuming clawback does not apply. As an extremely unrealistic example to illustrate the point, a couple with $20 million of assets may have about $10 million of assets subject to estate taxes if they die after the exclusion amount has been reduced to $5 million (ignoring indexing of the exclusion amounts), resulting in $4 million of estate tax. The $4 million of estate tax could be avoided entirely by making $20 million of gifts utilizing each of the the spouses' $10 million (indexed) gift tax exclusion amounts. (Of course, in that circumstance, the grantor would want to take steps to be potential recipient of at least some portion of the transferred amounts, as explored in Item 13.j.(6)-(7) below.)

(2) **Cushion Effect**. Perhaps the most important advantage of the increased gift tax exclusion amount for many individuals will be the "cushion" effect – the ability to make gifts in excess of $5 million, but considerably less than $11 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). Clients who have been reluctant to implement transfer planning strategies in the past because of fear of the possible assessment of a current gift tax will be much more comfortable making transfers with cushion effect of the $11 million gift tax exclusion amount.

(3) **Decreased Emphasis on Defined Value Transfers**. 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 gift transactions the complexity of defined value transfers.

(4) **Specific Gift Opportunities**.

- Gifts to Dynasty trust to utilize $10 million (indexed) GST exemption (or making a late allocation of GST exemption to previously created trusts if the donor does not want to make further gifts);

- Forgiveness of outstanding loans to children;
- Gifts to grantor trusts, and leveraging grantor trusts with loans or sales from the grantor;
- Equalizing gifts to children or grandchildren;
- Gifts to save state estate taxes (very few states treat gifts as reducing estate exemption amounts, even for gifts made within three years of death in gross estates);
- GRATs (GRATs will continue to be advantageous even with the $10 million (indexed) gift tax exclusion amount);
- Life insurance transfers (including the ability to "roll out" of split dollar arrangements);
- Deemed §2519 transfers from QTIP trusts (for an outstanding detailed discussion of planning by a surviving spouse with QTIP trusts, see Read Moore, Neil Kawashima & Joy Miyasaki, Estate Planning for QTIP Trust Assets, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12 ¶ 1202.3 (2010));

These specific gift strategies are discussed in more detail in Item 5.o-aa of the 2012 Heckerling Musings and Other Current Developments Summary found **here** and available at **www.Bessemer.com/advisor**.

(5) **Trust Sales**. For mega-wealthy clients, trust sales can be magnified on (super steroids) using the increased gift tax exclusion amount. Using a rule of thumb of having 10% equity to support a sale to a trust, spouses could fund grantor trusts with $22 million of assets and sell nine times that, or almost $200 million of assets to the trusts in return for notes bearing interest at the AFR (although the IRS may question if that interest rate is sufficient).

For a pre-existing sale to grantor trust transactions, additional gifts could be made to the trust if needed to bolster the equity value of the trust (and to reduce the necessity of relying on guarantees) to support the bona fides of the sale transaction, and to reduce the risk of a §2036 attack against the grantor's retained interest via the note from the trust. In several recent cases, the IRS has taken the position that §2036 applies to sales to grantor trust transactions. For some previously completed sales transactions, gift to trusts may be sufficient to repay the notes entirely (or the notes could be forgiven) to remove any §2036 risk, at least if the repayment/forgiveness occurs at least three years prior to the grantor's death. Avoiding the risk of a protracted audit and litigation over the §2036 issue could be a significant perceived advantage.

(6) **Transfers with Possible Continued Benefit for Grantor or Grantor's Spouse**. Couples with $22 million of gift tax exclusion amount may significantly reduce their potential estate tax lability by making gifts to utilize the increased exclusion amount, particularly if either or both spouses die after 2025 when the estate exclusion amount is scheduled to decline to $5 million (indexed). But the couples making such large transfers will likely want some kind of potential access to or potential cash flow from the transferred funds.

Planning alternatives for providing some benefit or continued payments to the grantor and/or the grantor's spouse include:

- Spousal limited access trust ("SLAT") and/or exercise by beneficiaries of nontaxable powers of appointment (discussed in more detail in Item 3.j.(7) below);
- "Non-reciprocal" trusts;
- Self-settled trusts established in asset protection jurisdictions (and the more conservative approach may be to allow a third party to appoint assets to the settlor under a non-fiduciary power of appointment rather than including the settlor as a discretionary beneficiary under fiduciary standards);
- Transferring residence to trust or co-tenancies between grantor/spouse of grantor and trust;
- Preferred partnership freeze;
- Payment of management fees to the grantor;
- Inter vivos QTIPable trust; and
- Retained income gift trust.

Possible alternatives that do not shift value to the transferor but at least provide possible cash flow or a way to access specific trust assets include:

- Borrowing of trust funds by grantor;
- Sale for a note or annuity rather than making a gift of the full amount to be transferred, resulting in continued cash flow to the transferor; and
- "Reverse grantor trust" transaction in which the donor purchases (including through the exercise of a substitution power) or borrows assets gifted to trust.

Each of these alternatives is discussed in more detail in Items 14-24 of the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.Bessemer.com**.

(7) **SLATs**. One spouse funds 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 predeceased the client) in a manner that is excluded from the estate for federal and state estate tax purposes.

The original settlor could even become a discretionary beneficiary if the spouse predeceases as long as the settlor's creditors could not reach the trust assets under applicable state law, which could occur if DAPT laws apply to the trust or if state spendthrift trust law specifically protects against the settlor's creditors in the "surviving settlor" scenario. *E.g.*, TEX. PROP. CODE §§112.035(d)(2) (settlor becomes beneficiary under exercise of power of appointment by a third party), 112.035(g)(1) (marital trust after death of settlor’s spouse), 112.035(g)(2) (any irrevocable trust after death of settlor’s spouse), 112.035(g)(3) (reciprocal trusts for spouses). Accordingly, even couples in non-DAPT states may nevertheless be able to transfer substantial assets (up to $22 million using reciprocal/non-reciprocal trusts) to trusts that may benefit one of the spouses that may be protected from the creditor claims of both spouses.

In addition to avoiding estate inclusion, the trust also provides protection against creditors, elder financial abuse, and identity theft. Over time, the trust can accumulate to significant values (because it is a grantor trust, the client will pay income taxes on the trust income out of other assets) and can provide a source of funding for retirement years. (As with any inter-spousal transfers, clients should be aware of potential implications of the transfers on divorce.)

To maximize the creditor protection feature of SLATS (i) the trustee should have the ability to sprinkle distributions among various beneficiaries, (ii) at least one independent trustee should consent to distributions, (iii) any named trust protector should be someone other than the settlor, and (iv) the trustee should be authorized to permit beneficiaries to use assets (rather than having to make distributions for them to enjoy benefits of the trust).

For a detailed discussion of SLATs and “non-reciprocal” SLATs, see Items 16-17 of the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.Bessemer.com/Advisor**.

(8) **Upstream Gifts or Other Gifts to Moderate Wealth Individuals; §1014(e)**. Many parents of clients will have no federal estate tax concerns, even if the parents live past 2025 when the exclusion amount returns to $5 million (indexed)**.** While the gift tax exclusion amount is $10 million (indexed), a client may give/sell assets to a grantor trust for a third party (such as a modest-wealth parent of the client) who will have a testamentary general power of appointment in the trust. At the parent’s death, the inclusion of the assets in his or her estate may generate no estate taxes but the assets would receive a basis adjustment (although issues could arise under §1014(e) if the parent dies within a year of when the client creates the trust), and the parent could allocate his or her GST exemption to the assets. The assets might pass by default into a trust for the client’s benefit but that would not be in the client’s estate for estate tax purposes. For a detailed discussion of this planning alternative, see Item 7.c of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/advisor**.

If the client wants to use an upstream transfer but does not want to use the client’s gift tax exclusion amount in doing so, a GRAT could be used with the remainder interest passing to an upstream trust for the client’s parents.

Similarly, gifts may be made to other individuals who have no estate tax concerns in hopes of getting a basis increase at the individual’s death, and taking steps to avoid §1014(e) in case the donor should die within one year of the gift (for example, by having the assets pass into a discretionary trust for the original donor’s benefit rather than passing outright to the original donor, *cf.* PLR 90036036). For a detailed discussion of planning issues surrounding §1014(e), see Item 8.c of the Current Developments and

Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/advisor**.

(9) **Be Very Careful Before Making Lifetime Gifts of Low Basis Assets**. The estate tax savings of gifts are offset by the loss of a basis step-up if the client dies no longer owning the donated property. For example, a gift of a $1 million asset with a zero basis would have to appreciate to approximately $2,470,000 (to a value that is 247% of the current value) in order for the estate tax savings on the future appreciation ($1,469,135 x 40%) – if the estate tax is not repealed – to start to offset the loss of basis step-up ($2,469,135 x 23.8% for high bracket taxpayers). The required appreciation will be even more if state income taxes also apply on the capital gains.

(10) **Report Transactions on Gift Tax Returns With Adequate Disclosure**. Many planners encourage clients to file gift tax returns to report gift or non-gift transactions to start the statute of limitations. Otherwise, the possibility of owing gift tax on an old transaction is always present. The historic rate for auditing gift tax returns is about 1%, and this rate has not been rising in recent years (although more gift tax returns may be reviewed in the future as the number of taxable estates decreases).

In order to start the statute of limitations, the return must meet the adequate disclosure requirements of Reg. §301-6501(c)-1(f). *See e.g.*, Field Attorney Advice 20152201F (requirements not satisfied); PLR 201523003 (adequate disclosure can foreclose later attacks on issues other than valuation such as whether a split gift election was properly made). For a detailed discussion of the background and planning issues around the adequate disclosure rules see Item 20 of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

(11) **Emphasis on Flexibility.** Flexibility will continue to be a focus point for planning.

- **Limited Powers of Appointment**. Liberal uses of limited powers of appointment provide flexibility. See Item 8.m below. Turney Berry has stated "We sprinkle powers of appointment like pixie dust."

- **Broad Discretion Over Distributions**. Allowing broad discretionary distributions of trust assets to a broad class of beneficiaries by an independent trustee adds flexibility.

- **Substitution Powers**. Use non-fiduciary substitution powers to cause grantor trust status (which also yields great flexibility for the donor to purchase favored or low-basis assets from the trust) and include provisions authorizing someone other than the donor to remove the substitution power. This will be balanced against a desire in some situations of using non-grantor trusts, to utilize the exemptions and thresholds available for purposes of the state and local taxes deduction (with its $10,000 limit per taxpayer) and the §199A deduction (with its exceptions applicable for taxpayers with income below $157,500 ($315,000 for joint returns)(indexed).

- **Trust Protectors**. Consider giving an independent person (sometimes referred to as a "trust protector") broad flexibility to modify the trust based on changes in tax laws or if the donor's "net worth drops below a certain level that is unforeseen and independently significant." Alan Gassman, Christopher Denicolo, Kenneth

Crotty & Brandon Ketron, *The Reversible Exempt Asset Protection ("REAP") Trust for 2017 Planning*, LEIMBERG ESTATE PLANNING NEWSLETTER #2500 (January 11, 2017) (hereinafter "Gassman et al, "REAP Trust").

- **Trust Protector Causing Inclusion in Grantor's Estate**. The trust could also give a trust protector (with the limitations described above) the power to grant a power to the donor that would cause inclusion in the grantor's gross estate (such as a limited power of appointment, which would cause estate inclusion under §2038 if the estate tax is not repealed) (*see* Martin Shenkman & Jonathan Blattmachr*, Not So Hard to Figure: The Critical Importance of Current Continuous Estate Planning*, LEIMBERG ESTATE PLANNING NEWSLETTER #2491 (Dec. 19, 2016). But see possible caveats discussed at Item 3.i.(1) above.

- **Trust Protector Adding Donor as Beneficiary; DAPT States**. Considering giving a trust protector the ability to add the donor as a discretionary beneficiary if the trust is established under the laws of a domestic asset protection trust state "if described conditions are satisfied, such as the donor's net worth dropping below a certain level, if the federal estate tax is repealed, or the protector determines that the estate tax is no longer a concern to the donor's family." *Id.* The grantor might include himself or herself as a discretionary beneficiary of the trust from the outset if the grantor resides in a self-settled trust (DAPT) state, though being a possible appointee under a non-fiduciary power of appointment may be a more conservative alternative.. If the grantor lives in another state and attempts to apply the laws of a DAPT state, the laws of the domicile state may nevertheless apply under the "strong public policy" exception from being governed by the choice of law provision in the trust agreement. In addition, a debate is ongoing about comment 2 under §4 of the Uniform Voidable Transactions Act (formerly the Uniform Fraudulent Transfer Act), which may cause a transfer by a person from one state that has no legislation regarding self-settled trusts to a trust governed by the laws of a DAPT state as being voidable *per se*.)

- **Limitation on Trust Protector Powers.** The "REAP Trust" article suggests including various limitations on the trust protector and protector powers:

  - Use a committee of at least three trust protectors (trusted individual or financial institutions) with appropriate checks and balances in place between them;
  - Provide a mechanism for the succession and possible replacement of trust protectors;
  - The donor should not have the power to remove and replace any of the trust protectors or exercise any of their powers;
  - Trust protector powers should not be conditioned on approval of the donor or any individual related or subordinate to the donor;

    The trust protector powers should be exercisable only in their sole and absolute discretion. Gassman et al, "REAP Trust."

k. **Be Very Careful Before Making Lifetime Gifts of Low Basis Assets**. The estate tax savings of gifts are offset by the loss of a basis step-up if the client dies no longer owning the donated property. For example, for a client that has previously fully used available exclusion amounts, a gift of a $1 million asset with a zero basis would have to appreciate to approximately $2,470,000 (to a value that is 247% of the current value) in order for the estate tax savings on the future appreciation ($1,469,135 x 40%) to start to offset the loss of basis step-up ($2,469,135 x 23.8% for high bracket taxpayers). The required appreciation will be even more if state income taxes also apply on the capital gains.

l. **Avoiding Funding Bypass Trust.** Countless situations will arise in which a spouse dies with a traditional formula bequest in a will that has not been reviewed in years that creates a bypass trust when the couple has no federal estate tax concerns at the surviving spouse's subsequent death. Creating the bypass trust will create administrative complexity that the surviving spouse may want to avoid and, perhaps more importantly, will eliminate any basis step-up for trust assets at the surviving spouse's death (because he or she would not own the trust assets). For various planning strategies, see Item 6.c of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

m. **Revised Charitable Planning Paradigms**. Because no necessity would exist for an estate tax charitable deduction if the estate tax will not apply because of the increased basic exclusion amount, a new paradigm would apply to charitable dispositions at death for decedents with assets under the increased basic exclusion amount who are likely to die before sunsetting occurs in 2026.

- In a family with unified goals about charitable transfers, consider making bequests to individual family members and allowing them to make lifetime gifts to the same desired charities, giving the individuals an income tax deduction. Alternatively, the desired amount of charitable bequest could be funded out of mandatory annual distributions from a trust over various years, structured so that the §642(c) charitable deduction would offset taxable income of the trust.
- Charitable bequests to trusts would no longer have to be in the form of a qualified interest. Assets could be left to a trust providing that all income would be paid to charity, which would allow the trust to receive a §642(c) income tax deduction, thus, reducing the trust's DNI to zero, meaning that trust distributions to others would not carry out income to them.

n. **State Tax Planning; Domicile**. State estate and income tax planning will continue to be important. Domicile planning (to eliminate or reduce contacts with high-tax states) can be significant to minimize state taxes and may be especially important in light of the Act's limiting the SALT deduction to only $10,000 per year.

o. **Selection of Entity and Business Restructuring**. The Act raises new factors in the selection of entity decision for businesses and may lead to business restructuring efforts to make maximum use of the new §199A deduction for qualified business income. These issues include whether the entity should be structured as a C corporation (to take advantage of the lower tax rate on current income, but realizing that a subsequent dividend tax applies as dividends are withdrawn by shareholders), and whether a business in a "specified service" industry taxed as a pass-through entity should be divided so that a separate firm would provide ancillary administrative support (such as secretarial services, accounting, document management, information technology support, etc.) that would charge the "specified service" company for its support services, hoping that the business income of the support entity would qualify for the §199A deduction.

p. **Income Shifting**. The increased gift tax exclusion amount may afford the practical ability for some clients to fund non-grantor trusts for income shifting purposes. To the extent that the grantor wished to be a discretionary beneficiary of the trust, the general structure of an ING-type trust could be used (except it would be a completed gift trust), or a SLAT could be structured with ING-type provisions. *E.g.,* IRS Letter Rulings 201744006-008 (examples of the many rulings that have addressed "DING" trusts).

q. **Undoing Prior Planning**. If the estate tax had been repealed, some clients may have wanted to undo prior planning that was implemented to avoid the estate tax. That will be less significant in light of the fact that the doubling of the basic exclusion amount only lasts eight years. See Item 6.I of the Current Developments and Hot Topics Summary (December 2016) found **here** and Item 6 of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor** for a discussion of possible issues about undoing prior planning.)

r. **Partnerships with Preferred Partnership Interests**. A donor may create a partnership and retain the right to a preferred return and give to an irrevocable trust the common interest that has the right to excess return and appreciation. The preferred return may end up being much of the income produced by the partnership; in effect the donor is making a gift of future appreciation (to the extent the partnership grows above the preferred return) but *gets to keep much (if not all) of the income* produced by the partnership. Only the preferred interest is included in the estate (plus cumulative payments on the preferred interest that have not been consumed). *See Estate of Boykin v. Commissioner*, 53 T.C. Memo 297 (1987) (decedent gave voting common stock and retained nonvoting preferred stock; IRS argued that the gifted voting stock was included in the gross estate under §2036(a)(1) because the decedent retained "nearly all the income from the transferred property"; court disagreed because the "only rights decedent retained were those accorded to the … nonvoting shares he retained, which were separate and distinct rights from the rights enjoyed by the voting shares that he transferred"). *See also Hutchens Non-Marital Trust v. Commissioner*, 66 T.C. Memo 1993-600 (1993) (interest that the decedent held in his family-owned corporation prior to recapitalization was not includible in his gross estate under §2036 because the decedent received adequate consideration for the pre-recapitalization stock, the decedent retained no interest in stock surrendered in the recapitalization, and the decedent's post-recapitalization control and dividend rights came from new and different forms of preferred stock that he received in the recapitalization).

Alternatively, a noncumulative preferred interest (that does not comply with §2701 could be retained and the common stock could be given. The preferred stock would have a zero value, and the client would need enough gift exemption to cover the common stock. If the estate tax is not repealed at the client's death, the full value of the preferred stock (presumably its liquidation value at par) would be included in the gross estate (resulting in a basis step), but in calculating the estate tax, the use of the unified credit caused by valuing the preferred at zero would be restored under Reg. §25.2701-5(a)(3). The noncumulative retained preferred interest permits some flexibility in the cash flow that will actually be paid to the client (although substantial compliance with the partnership agreement is preferable to avoid potential gift or §2036 consequences.) *See* Michael N. Gooen & Tracy A. Snow, *Tasty Freeze: Preferred Partnership Tax Recipe*, 42 ESTATE PLANNING 5 (May 2015) and Christopher Pegg and Nicole Seymour, *Rethinking I.R.C. § 2701 in the Era of Large Gift Tax Exemptions*, 87 FL. BAR J. 9 (Nov. 2013). See Item 10.c of the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.Bessemer.com/Advisor** for an example by Ellen Harrison of this planning alternative.

Using preferred partnerships is a sophisticated strategy requiring customized provision in the partnership agreement and requiring a special appraisal of the preferred and common. [Lou Harrison (Chicago, Illinois): "These are good, but I will use GRATs 99% of the time."]

s. **Report Transactions on Gift Tax Returns With Adequate Disclosure**. Many planners encourage clients to file gift tax returns to report gift or non-gift transactions to start the statute of limitations. Otherwise, the possibility of owing gift tax on an old transaction is always present. The historic rate for auditing gift tax returns is about 1%, and this rate has not been rising in recent years.

In order to start the statute of limitations, the return must meet the adequate disclosure requirements of Reg. §301-6501(c)-1(f). For a detailed discussion of the background and planning issues around the adequate disclosure rules see Item 20 of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

The IRS has been taking a rather strict approach in applying the adequate disclosure rules, for example concluding that they were not satisfied where (i) partnerships were not identified correctly, (ii) one digit was left off each partnership's taxpayer identification number, (iii) the description said that the land owned by the partnership was appraised by a certified appraiser, but the appraisal was not attached and the appraisal did not value the partnership interests, and (iv) the description summarily stated that "Discounts of __% were taken for minority interests, lack of marketability, etc., to obtain a fair market value of the gift." Field Attorney Advice 20152201F.

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

t. **Testamentary Discount Planning Not As Important**. Even before the estate tax is repealed, planning to produce valuation discounts at an individual's death has diminishing savings. The estate tax may be lower, but the basis will also be lower, resulting in higher income taxes at some point when the beneficiary ultimately sells the assets (or sooner if the assets can be depreciated). With a 40% estate tax and a 23.8% income tax on capital gains (or higher if the state has a state income tax), the savings may be fairly low. If the estate tax is repealed, discount planning can actually be disadvantageous if basis adjustment at death is retained.

u. **Many Planning Issues beyond Federal Estate Tax Planning.** Remember all the many things that estate planners do beyond planning for the federal estate tax. Following the passage of ATRA, Lou Mezzullo, President of the American College of Trust and Estate Counsel, sent a letter to ACTEC Fellows reminding them of the many services that professionals provide to clients other than federal transfer tax planning. He provides the following list, not meant to be exhaustive, of some of those items (quoted with his permission).

1. Planning for the disposition of the client's assets at his or her death.
2. Asset protection planning.
3. Planning for disability and incompetency.
4. Business succession planning (without the estate tax to blame for failure of a business).
5. Planning for marital and other dissolutions.
6. Charitable giving (for its own sake, and because income tax considerations will still be relevant and techniques, such as lifetime charitable remainder trusts to facilitate diversification, would not be affected at all).
7. Life insurance planning (other than to provide funds to pay taxes).
8. Fiduciary litigation (enhanced because more to fight over).
9. Retirement planning.
10. Planning to pay state death taxes (in many states).
11. Planning to avoid or minimize gift taxes (and client desires to gift more than the $5 million (indexed) basic exclusion amount for gift tax purposes).
12. Using business entities to accomplish nontax objectives.
13. Planning for children with disabilities.
14. Planning for spendthrift children.
15. Planning for clients with real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues (in addition to state estate tax).
16. Planning for clients who are U.S. citizens or resident aliens who own property in other countries.
17. Planning for nonresident aliens with assets in the U.S. or who plan to move to the U.S.
18. Planning for citizens who intend to change their citizenship.
19. Planning for possible decrease in the estate, gift, and GST tax exemptions and/or increase in the transfer tax rates.

20. Planning to pay education expenses, including contributing to I.R.C. §529 plans.

21. Planning to deal with non-tax regulatory issues, such as the Patriot Act, HIPAA, and charitable governance reform.

22. Identifying guardians for minor children, if and when needed.

All of these issues (and various other non-tax issues) would still be important for clients.

v. **Keep Perspective**. Michael Graham (Dallas, Texas) reminds planners of the importance of estate planning beyond saving estate taxes, pointing out that planners assist broadly in the "transporting" of capital from one generation to the next.

Michael observes:

I continue to maintain that not a single less person will die needing at least a Will, not a single less person will have, or be married to, children from a prior marriage. There will continue to be children of great promise and children faced with great challenges. The fact that my lovely wife June would not need to worry about the marital deduction any more doesn't mean she would give everything outright to me at her death. She knows me too well after 47 years of marriage.

Even now, the truth is that for most of our planning, divorce is more likely than death. I did an Ethics presentation for the annual NAELA meeting this year on representing H and W. The statistics are that 70% of second marriages in which there are children from a prior marriage will end in divorce within 5.5 years. Think about that. Even now, we are drafting in anticipation of divorce, not death.

We are not the railroad unless we treat ourselves as such. We are transportation. We assist in transporting capital from one generation to the next.

4. Basis Consistency and Reporting Requirements

The basis consistency and reporting requirements enacted in 2015 create basis consistency requirements for beneficiaries and cumbersome reporting obligations for executors.

a. **Background**.

(1) ***Prior Law (and Continuing Law For Many Estates) Allowing Inconsistent Valuation Positions Under §1014(a) in Certain Situations.*** For purposes of determining the basis of assets received from a decedent, the value of the property as determined for federal estate tax purposes generally is deemed to be its fair market value. Treas. Reg. §1.1014-3(a). The estate tax value is not conclusive, however, but is merely a presumptive value that may be rebutted by clear and convincing evidence except where the taxpayer is estopped by the taxpayer's previous actions or statements (such as by filing estate tax returns as the fiduciary for the estate). Rev. Rul. 54-97, 1954-1 C.B. 113. See Item 3.a.(1) of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor** for various relevant cases.

(2) ***Legislative Proposals.*** The President's Budget proposal for fiscal years 2010-2016, included a provision requiring gift transferees to use the donor's basis (except that the basis in the hands of the recipient could be no greater than the value of the property for gift tax purposes) and that the basis of property received by death of an

individual would be the value for estate tax purposes. A legislative proposal of that approach was contained in section 6 of the Responsible Estate Tax Act of 2010 (S. 3533 and H.R. 5764), in the December 2010 "Baucus Bill," in section 5 of "The Sensible Estate Tax Act of 2011" (H.R. 3467), Section 1422 of Ways and Means Committee Chairman Dave Camp's Discussion Draft released February 26, 2014, and in section 5 of the "Sensible Estate Tax Act of 2015" (H.R. 1544).

b. **Legislative Provision in Surface Transportation and Veterans Health Care Choice Improvement Act**. The basis consistency provisions for property received from a decedent (but not the consistency proposals for gifts) were enacted as Section 2004 of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (the "Act"), which extended funding of the "Highway Trust Fund" for three months through October 29, 2015 (but this revenue provision was permanent), and which was signed into law July 31, 2015. The legislation added new §1014(f) (basis consistency requirement), §6035 (reporting requirements), and changes to certain penalty provisions making them applicable to these sections.

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

Value Limit. Section 2004 of the Act added new §1014(f), which provides that the basis of property to which §1014(a) applies (i.e., property acquired from a decedent) shall not exceed the final value determined for estate tax purposes (and detailed provisions govern when the tax is finally determined), or if the final value has not been determined, the value provided in a statement to the decedent's recipients.

Exception If Property Does Not Increase Estate Taxes. This provision applies only to property "whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11 … on such estate." The regulations and IRS Form 8971 have clarified that this limitation means the consistency provision does not apply if the estate does not exceed the available exemption amount and does not apply to property qualifying for the marital or charitable deductions. Unfortunately, however, no similar exception is included in the information reporting requirements in new §6035, discussed immediately below.

Not Applicable During Estate Tax Repeal. The basis consistency provision will not apply to beneficiaries of estates of decedents who die during any time that the estate tax is repealed.

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

***What Estates Must Report*?** If the estate is required to file an estate tax return under §6018(a), the executor is required to give valuation information reports to the persons described below.

Not Applicable During Estate Tax Repeal. The reporting requirements will not apply for estates of decedents who die during any time that the estate tax is repealed (because no estate tax return would be required for those estates).

***Who Receives Reports*?** Estates that are required to file estate tax returns must give reports to both the recipients (i.e., "each person acquiring any interest in property included in the decedent's gross estate") and the IRS. §6035(a)(1).

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

Extensions of Due Date for Information Reports. Notices and regulations have clarified that persons required to give reports "need not do so" before June 30, 2016. Reg. §6035-2 (issued Dec. 1, 2016).

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

e. **Penalties**.

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

(2) ***Penalties for Failure to Provide Information Returns and Statements.*** Penalties for the failure to file correct "information returns" or "payee statements" are provided in §§6721 and 6722, respectively. The penalty is generally $250, lowered to $50 per failure, if the information return is filed within 30 days of the due date. (These amounts are inflation adjusted.) The Instructions make clear that only one penalty applies for all failures relating to a single filing of a Form 8971 (even if multiple problems with the Form exist) and one penalty applies for all failures related to each Schedule A.

If the failure to furnish the required information return or statement is "due to intentional disregard" of the requirement to furnish the return or statement, the statute provides for a penalty of $500 (inflation adjusted) or if greater, "10 percent of the aggregate amount of the items required to be reported correctly." §§6721(e) and 6722(e). ***Thus, the penalty under the statute could be quite large for intentionally disregarding the requirement to file the information returns or statements.*** Interestingly, the Instructions to Form 8971 do not refer to a possible penalty of 10% of the estate, but merely state that if the failure to file Form 8971 or a Schedule A is due to intentional disregard, "the penalty is at least $530 per Form 8971 and the Schedule(s) A required to be filed along with it, with no maximum penalty."

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

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

f. **Effective Date**. The amendments to §§1014(f), 6035 and 6724(d) described above "shall apply to property with respect to which an estate tax return is ***filed after*** the date of the enactment of this Act." §2004(d) of the Act. This applies not only to returns required after but also to any returns actually filed after the date of enactment (July 31, 2015). See Item 3.i.(1) of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor** for a discussion about supplemental estate tax returns filed after the effective date.

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

- Part I of Form 8971 lists general information about the decedent and executor.
- Part II lists information about beneficiaries (including TIN, address, and the date that Schedules A are "provided" to each beneficiary).
- A Schedule A is attached to provide information to each estate beneficiary. The Schedule A includes the Form 706 Item number and description of property that the beneficiary has acquired from the decedent. For each asset listed, the executor indicates whether the asset increases estate tax liability and provides the valuation date and value. Schedule A contains a "Notice to Beneficiaries" directing the beneficiary to retain the schedule for tax reporting purposes and informing the beneficiary that if the property increased the estate tax liability, the Code requires consistent reporting of basis.
- If the executor is also a beneficiary, the executor will have to send a Schedule A to himself or herself. (The Instructions state that if the executor is also a beneficiary, "the executor is a beneficiary for purposes of the Form 8971 and Schedule A.")
- The executor is directed to "[s]ubmit Form 8971 with a copy of each completed Schedule A to the IRS." The Instructions direct the executor to file the Form 8971 with all Schedules A to the IRS within 30 days after the due date (but if the return is filed late, within 30 days of the filing date) of the estate tax return. The Form 8971 and attached Schedule(s) A are not to be filed with the Form 706, but must be filed separately. If values are adjusted, a Supplemental Form 8971 and Schedules A must be filed with the IRS within 30 days after the adjustment.
- Beneficiaries only receive Schedules A and not the Form 8971 itself. The Schedules A must be "provided" (in person or by email, U.S. mail or private delivery service) within 30 days of the due date of the estate tax return (or within

30 days of the filing date if the return is filed late). If adjustments are made to assets listed on the estate tax return (such as values or the inclusion of additional assets), an updated Supplemental Schedule A must be given to each affected beneficiary within 30 days of the adjustment.

- If a beneficiary's distributions have not been funded when the Form 8971 is filed, the Instructions instruct (the stricken words were in the January 2016 Instructions, replaced in the September 2016 Instructions with the bold-font words):

  > the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary's distribution on that beneficiary's Schedule A. (This means that the same property may be reflected on more than one Schedule A.) A supplemental Form 8971 and corresponding Schedule(s) A ~~should~~ **may, but aren't required to** be filed once the distribution to each such beneficiary has been made.

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

September 2016 Instructions. The IRS published revised draft instructions to Form 8971 in June, 2016 (with a September, 2016 Revision Date). That draft was further revised and released on October 13, 2016 as official revised Instructions (with a September, 2016 date). The new Instructions are substantially the same as the January 2016 version. Some of the significant changes are described below.

- The June 2016 draft instructed not to include any attachments to Schedule A. Those sentences were deleted in the final September 2016 Instructions, and specific authority to list bulk assets in certain situations was authorized:

  > Listings of bulk assets may be attached to Schedule A in lieu of a detailed description of each item that has been acquired (or is expected to be acquired) by a beneficiary. The listing should consist of a related property (for example, stocks held in a single brokerage account) and only include information relevant to basis reporting such as name/description of the property, value, and valuation date. Do not attach property appraisals to Schedule A.

- The "Who Must File" section clarifies that a Form 8971 is not required for an estate that files an estate tax return file solely to elect portability.
- For unfunded bequests, when Schedule(s) A identify several beneficiaries who might receive the same property, "the estate may, but isn't required to, file a supplemental Form 8971 and Schedule(s) A to specify the actual distribution of that property among the identified beneficiaries."
- The "Penalties" section makes clear that an executor may be subject to penalties for failing to file Forms 8971 and Schedule(s) A even if no tax was due on the estate tax return.
- If a beneficiary does not have a TIN and one is requested from the beneficiary in writing by the executor, the Form 8971, Part II, column B should enter "requested" for that beneficiary, and a copy of the solicitation should be attached. "A supplemental Form 8971 and corresponding Schedule A must be filed with the IRS once the TIN has been obtained." If a foreign beneficiary isn't required to provide a TIN, enter "Not Required" in the TIN entry space.

- The January 2016 Instructions required attaching a Form 2848, Power of Attorney. The September 2016 instructions provide more detail, including: (i) in line 1, the executor is the "taxpayer" and the executor's TIN should be listed; and (ii) in line 3,"enter 'Civil Penalties' in the Description of the Matter column, 'Form 8971/Schedule A' in the Tax Form Number, and the decedent's date of death using the four-digit year and two-digit month as 'YYYYMM' in the Year(s) or Period(s) column." [Observation: "Civil Penalties"??? Yikes!!]
- The Schedule A section clarifies that cash isn't reportable: "A cash bequest acquired (or expected to be acquired) by a beneficiary isn't considered reportable property for purposes of Form 8971/Schedule A." [That sentence's reference to "Form 8971/Schedule A" instead of just referring to "Schedule A" suggests that a beneficiary who is only receiving cash would not be listed in Part II of Form 8971. Including that beneficiary on Part II of Form 8971 would not make sense because column D requires specifying the date that valuation information is provided to beneficiaries and no Schedule A would be provided to that beneficiary.]
- The Schedule A section also clarifies that values to be reported on Schedule A are the estate tax values, without reflecting any post-death adjustment in value, and are the full gross values of property, unreduced by "mortgages, non-recourse indebtedness, or other decreases in equity." It also clarifies that if multiple beneficiaries receive partial interests in the same property, proportional values should be listed for each beneficiary.

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

Temporary and proposed regulations, released March 2, 2016 (and published in the Federal Register on March 4, 2016), provide additional guidance regarding the basis consistency and information reporting requirements of new §§1014(f) and 6035. Some of the highlights and surprises include the following:

- The final value for estate tax purposes sets the *initial* basis; normal post-death basis adjustments are still applicable;
- For property subject to non-recourse debt, the basis is the gross value of the property, not just the net value reported on the estate return;
- The reporting requirement does not apply to estates that are not required to file estate tax returns but do so merely to make the portability election;
- Property that qualifies for the marital or charitable deduction is not subject to the basis consistency requirement, but is subject to the reporting requirements;
- Tangible personal property that does not have a marked artistic or intrinsic value over $3,000 is not subject to the basis consistency or reporting requirements;
- After-discovered or omitted property gets a basis of zero if the property is not reported on an estate tax return before the period of limitations on assessments has expired;
- The Form 8971 and Schedule(s) A to beneficiaries can omit cash, IRD, tangible personal property (as described above), and property sold before the information reports are due;

- For bequests to a trust, estate or entity, the Schedule(s) A are given to the trustee, executor or entity (not the trust beneficiaries);
- For life estates, Schedule(s) A must be sent to the life tenant and presumptive remainderman (and if the initial remainderman dies before the life tenant, the executor apparently must send supplemental reports to the IRS and to the new remainderman);
- If the executor has not determined what property will be distributed to a beneficiary when the information report is due, all property that could be used to satisfy the bequest must be included on the Schedule A to that beneficiary (and the executor does not have to send supplemental reports to the IRS and to that beneficiary after the bequest is funded);
- The executor must file a supplemental Form 8971 with the IRS and send supplemental Schedule(s) A to beneficiaries if any previously reported information is incorrect or incomplete (such as if the final estate tax value is changed), but a supplement is not needed for inconsequential errors or omissions;
- If a recipient of an asset in the gross estate makes a subsequent gift or distribution to a "related transferee" (which, for some strange reason, includes a grantor trust but not a non-grantor trust for a related party) the recipient must file a Schedule A with the IRS and transferee reporting the change in ownership and final estate tax value of the property; and
- The Form 8971 and Schedule(s) A to each beneficiary are due 30 days after the earlier of the due date or the date the estate tax return is actually filed (as required by the statute); the proposed regulations do not adopt the relaxation of the due date in the Instructions to Form 8971 saying that if the estate tax return is filed late, the information reports are not due until 30 days after the date the return is actually filed.

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

(1) **Detailed Summary**. For a more detailed discussion of details in the proposed regulations, see Item 3.i of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**. Some of the particularly unclear or controversial sections in the proposed regulations are discussed below.

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

This "zero basis rule" has been controversial. Commentators have observed that no requirement exists to supplement an estate tax return that was filed in good faith. If a preparer determines that no obligation to amend a return exists to report omitted property, the failure to report the property may result in a 40% estate tax savings, but that savings may be offset by a 23.8% federal capital gains tax (plus any state capital gains tax) or an even higher income tax attributable to the inability to depreciate the property or situations that may generate ordinary income. If the recipient of the after-discovered asset is not the party responsible for paying estate tax with respect to that asset, the executor may be put in an inherent conflict situation; the party who bears estate taxes will not want the property reported but the party who receives the asset will want it reported to have a basis equal to the date of death value of the asset.

Commentators have argued that §1014 provides no statutory authority for this rule. The IRS responds that §1014(f) provides that the basis cannot exceed the finally determined estate tax value, and if an asset is not reported on an estate tax return, that value is zero. Cathy Hughes (with the Treasury Department) notes that the IRS received many comments about this provision and Treasury and the IRS are exploring how to resolve the concerns, but they think the proposed regulations state what the statute requires.

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

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

(4) **Undistributed Property (Undetermined Beneficiary).** The ***most controversial*** provisions in the proposed regulations are the reporting requirements for bequests that have not been funded by the due date of the reports. If the executor has not decided what property will be distributed to each beneficiary by the due date of the information statement (30 days after the estate tax return due date), "the executor must report on the Statement for each such beneficiary all of the property that the executor could use to satisfy that beneficiary's interest." Prop. Reg. §1.6035-1(c)(3). In effect, "mini-706s" will have to be given to each such beneficiary listing all remaining property in the gross estate, other than cash, IRD, or certain tangible personal property. The preamble acknowledges that this will result in duplicate reporting of assets on multiple Schedules A. If the executor has "determined" what property will be distributed to a beneficiary but simply has not made the distribution

when the information statement is due, this special provision would not literally apply, and presumably the executor would list the property that the executor has determined will be used to satisfy that beneficiary. *See* Prop. Reg. §1.6035-1(e)(3)(ii)Ex.1. After the executor later determines what property will be used to satisfy a particular beneficiary's interest, "the executor may, but is not required" to file a supplemental return with the IRS and a supplemental statement with the beneficiary. Presumably the beneficiary would not need a supplemental statement because the beneficiary would know what property was actually received and can find the property listed on the initial statement.

The September 2016 Instructions to the Form 8971 are consistent, stating that revised Schedule(s) A "may, but aren't required to be filed once the distribution to each such beneficiary has been made."

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

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

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

Persons attending the hearing about the proposed regulations are hopeful that the IRS's approach to this issue will be revised when the final regulations are issued.

The AICPA has sent a letter to Congressional leaders (dated August 31, 2016) suggesting that the §6035a)(3) due date for sending statements to beneficiaries who have not yet received distributions should be extended.

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

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

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

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

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

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

> Whether or not the creation of a perpetual chain of title to aid the IRS in enforcement of section 1014(f) may be desirable as a matter of policy, it is not the policy Congress reflected in section 6035 when it limited the reporting requirement to an "executor," and, indeed explicitly eliminated

from the Administration's legislative proposal the statutory imposition of a similar reporting requirement on donors of gifts.

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

Another uncertainty exists as to a "re-transfer" from a trust by the exercise of a power of appointment. Whether reports must be sent following the exercise of a power of appointment that appoints property that was in the decedent's gross estate is unclear.

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

Subsequent Distribution From Individual Recipient to a Grantor Trust. If the recipient/transferor is an individual who makes a transfer to a grantor trust, the individual would have to provide information Statements to the IRS and the trustee of the grantor trust. The ACTEC Comments take the position that the subsequent transfers reporting rule should not apply for re-transfers to grantor trusts, suggesting that the proposed regulations "inadvertently omitted the word 'not.' The rule should logically apply to 'any trust if which the transferor is *not* a deemed owner for income tax purposes.' (emphasis added)."

Subsequent Re-transfer. If a transfer is made and reported, must a subsequent re-transfer by the first transferee also be reported? The proposed regulation is ambiguous, and the ACTEC Comments take the position that having the subsequent transfers reporting rule extend into perpetuity is unnecessary.

Due Date. The supplemental Statement must be given to the IRS and the transferee within 30 days of the date of the distribution or other transfer. Prop. Reg. §1.6035-1(f).

Information Statement. The term "Statement" is defined to be Schedule A of the Form 8971 (or any successor schedule issued by the IRS). Prop. Reg. §1.6035-1(g)(3). Therefore, information regarding subsequent transfers will be described on a

Schedule A (both to the transferee and the IRS). This is different from the way that basis consistency information is given to the IRS in all other circumstances; in other situations the IRS is advised with an "information return" (which is Form 8971), but in this situation both the IRS and recipient are advised using a Schedule A.

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

Is Reporting Required After Recipient Has Died? Comments to the IRS have asked for clarification about whether the reporting requirements on subsequent transfers end after the recipient of the property dies and the property is included in his or her estate. The property's basis would then be based on its fair market value at the time of the subsequent death, and reporting basis information about values at the original owner's death would be irrelevant (and misleading).

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

The zero basis rule may also lead to increased fiduciary liability. Commentators have observed that the zero basis rule penalizes the beneficiary, through no fault of the beneficiary. The beneficiary may look to the fiduciary for compensation of the lost basis adjustment as a result of omitting the asset from the estate tax return and not including it on a supplemental return before the statute of limitations runs on estate tax assessment.

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

One way of avoiding or minimizing the additional potential liability is for the executor to be more transparent in the preparation of the estate tax return. Some planners have questioned whether executors should seek to obtain releases from beneficiaries in connection with reported values or negotiated final values.

j. **Selected Practical Issues in Completing Form 8971 and Schedule A**.

(1) **Executor's EIN, Form 8971, Part I, Line 6**. The Instructions clarify that the executor is filing the Form 8971, not the estate. The executor's EIN is inserted on Line 6, not the estate's EIN. (The decedent's SSN is listed on Schedule(s) A passing to each beneficiary, not the executor's EIN.)

(2) **Number of Beneficiaries, Form 8971, Part II, Initial Sentence**. The Form asks how many beneficiaries receive property from the estate. The answer may lead to confusion, because a number of beneficiaries may only receive property within one of the exceptions and will not receive a Schedule A. Comments to the IRS have asked that this question be changed.

(3) **Is Filing Form 8971 Required If No Schedules Are Sent**? Caution would dictate filing a Form 8971 even if all property passing to beneficiaries is covered by an exception so that no Schedules A are filed. (In that case, the executor should include a note as to why no Schedules A are attached.) Comments have asked for clarification on the Form 8971.

(4) **"TIN," Form 8971, Part II, Column B**. The TIN of beneficiaries must be listed. Commenters have asked what to do if a trust has not been funded and no TIN has been obtained for the trust by the time of the due date of the Form 8971. Cathy Hughes (with the Treasury Department) has indicated that officials are pondering what to do about that situation.

(5) **"Date Provided," Form 8971, Part II, Column D**. A "Date Provided" column asks when the Schedule A was "provided" to each beneficiary. The Instructions require the executor to "keep proof of mailing, proof of delivery, acknowledgment of receipt, or other information relevant for the estate's records." The Instructions should be revised to clarify that the "date provided" is the date the executor sent the Schedule A under the "mailbox" rule. *See* Lester Law, *The New Basis Consistency and Reporting Requirements: Impacts, Traps and Compliance Concerns Using New Form 8971,* NOTRE DAME ESTATE PLANNING INST. at 52 (October 2016).

(6) **Signatures, Form 8971 But Not Schedule A**. The executor must sign the Form 8971 (under penalties of perjury) but not the Schedules A that are sent to the beneficiaries. In addition, a paid preparer who is paid to prepare the Form 8971 and/or any Schedule A must sign the Form 8971 as a paid preparer.

(7) **Schedule A, Description of Property, Part 2, Columns A-E**. Column A assigns an item number to each item listed on Schedule A.

Column B describes the Schedule and Item number of the asset on Form 706 and describes the property, using the same description used on the Form 706. If the beneficiary does not receive all of the property listed for that item on the Form 706, the Instructions say to "indicate the interest in the property the beneficiary will acquire." For example, this could be the number of shares of stock listed on Schedule B received by that beneficiary if not all of the shares listed on the Form 706 are distributed to that beneficiary. (Some of the shares might have been sold, or the shares may be distributed to multiple beneficiaries.) If a beneficiary receives a fractional interest in property that is in the gross estate, the fractional interest received by the beneficiary is listed, and "the value reported should reflect the proportional value of the partial interest for each beneficiary."

Column C lists "N" for property that passes in a way that qualifies for the marital or charitable deduction. Otherwise, Column C will say "Y." This will likely confuse beneficiaries receiving the Schedules A.

> Beneficiaries, of course, will likely have no understanding of the import of column C as it makes no sense even to a seasoned estate attorney that reporting is required even though the asset is not subject to the consistency of bases rules. Audrey Young, *The Consistency of Basis Rules and Other Post-Mortem and Gift Tax Developments*, 38th ANN. DUKE EST. PL. CONF. at 11 (Oct. 2016).

Column D lists the valuation date (either the date of death or the alternate valuation date). (While property that is sold during the 6-month alternate valuation period is valued as of that date on the Form 706, such property comes within the "property sold" exception from reporting and will not be listed on any beneficiary's Schedule A.)

Column E lists the value reported on the estate tax return. No post-death value adjustment is included. The gross value of property reported on the Form 706 is listed for property subject to non-recourse indebtedness even though the value listed on the estate tax return is just the net value of the property.

(8) **Schedule A, Description of Property, Part 2; Stock Portfolio Listed in a Brokerage Account**. An estate with a massive stock portfolio might require retyping massive securities listings on Schedules A for the beneficiaries. A June 2016 draft of the September 2016 instructions stated "Do not add any attachments to Schedule A" in several places. Those sentences were deleted in the final September 2016 instructions; a paragraph was added providing that listing of bulk assets of a related property (for example, stocks in a single brokerage account) may be attached to Schedule A. The Instructions state:

> Listing of bulk assets may be attached to Schedule A in lieu of a detailed description of each item that has been acquired (or is expected to be acquired) by a beneficiary. The list should consist of a (sic) related property (for example, stocks held in a single brokerage account) and only include information relevant to basis reporting such as name/description of the property, value, and valuation date. Do not attach property appraisals to Schedule A.

To the extent possible, the securities in large brokerage accounts should be valued on a valuation report listing the particular securities that will pass to a particular beneficiary, thus facilitating attaching that valuation statement to the Schedule A.

Some Form 706 preparation software programs can input a valuation report (such as an EVP report from EstateVal by Estate Valuations & Pricing Systems, Inc.) into the form, listing each stock as a separate asset (with CUSIP number, description, number of shares, etc.). The software program may have a Form 8971 feature to enter data from the Form 706 onto the Form 8971 and Schedule(s) A. This would be one way of listing each stock on the appropriate schedules. Alternatively, if the Form 706 lists an account as one item with an attached valuation list, the bulk asset listing alternative approach allowed under the September 2016 Instructions could be used.

(9) **Schedule A; Practical Problem in Reporting Actively Managed Brokerage Accounts**. Reporting actively managed brokerage accounts may require an intense amount of time and effort. If sales and reinvestments are being made throughout the period of administration, the executor will have to go through the brokerage statements with a fine-tooth comb to eliminate any securities that were sold by the estate, even if the estate may have re-acquired some of those securities at a later time. Reporting to a beneficiary on a Schedule A that the 1,000 shares of Apple stock

distributed to the beneficiary had a date of death value of $X as reported on the estate tax return would be extremely misleading if the estate had actually sold 400 shares and later re-purchased 400 shares. (The cost basis of those 400 shares would be the purchase price at the time of the purchase, not the date of death value reported on the Form 706.)

(10) **Schedule A "Notice to Beneficiaries."** The Notice to Beneficiaries at the bottom of Schedule A states as follows:

> You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. **Retain this schedule for tax reporting purposes.** If the property increased the estate tax liability, Internal Revenue Code Section 1014(f) applies, requiring the consistent reporting in basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional.

This notice is misleading in a number of respects. If property is not distributed by the due date of the Schedule A and all property that might be distributed in to the beneficiary is listed, the beneficiary will likely not actually receive all of the property included on the schedule. The statement in the Notice that the schedule lists "property you received" may lead the beneficiary to believe he or she is entitled to receive all of those listed assets.

In addition, the Notice should be revised to notify beneficiaries that they may need to file a Schedule A when an asset received from the gross estate is subsequently transferred to a related party.

(11) **Transmittal Letter for Schedule(s) A**. A beneficiary who merely receives a Schedule A in the mail will have no idea what it means or its importance (other than being told in the Notice to Beneficiaries at the bottom of the page that it is important for tax reporting purposes). And, as discussed immediately above, the Notice may lead the beneficiary to believe that he or she is entitled to receive all of the assets listed on the form even though the executor may, pursuant to the Instructions, merely be listing assets that could be distributed to the beneficiary.

Preparers will have to decide what kind of transmittal letter will be used to send the Schedules A. The preparer will want to provide helpful information but not lead the recipient to believe that the preparer represents the recipient. One approach is merely to tell the beneficiary to discuss the Schedule A with the beneficiary's tax advisor.

> This all begs the question of what exactly the attorney for the estate and the executor should be communicating to the beneficiary. In many estates, the executor will not have a fiduciary duty to the beneficiaries to whom Schedule A must be provided. One example is a joint tenant. An executor does not allow a fiduciary duty to the surviving joint tenant of property included in the decedent's estate.
>
> The executor may choose to send Schedule A to the beneficiary with a letter contextualizing the information reported on Schedule A and providing instruction on reporting subsequent carryover basis transactions. For estate attorneys and tax advisers, providing any information that could be construed as tax advice to non-client beneficiaries is a bad idea. This is leading some advisers to conclude that the optimal course of action is to simply tell beneficiaries to discuss the Schedule A with their tax advisor. Audrey Young, *The Consistency of Basis Rules and Other Post-Mortem and Gift Tax Developments*, 38th ANN. DUKE EST. PL. CONF. at 12 (Oct. 2016).

The problem of what to say to beneficiaries in the transmittal letter could be simplified if the IRS were to revise the next version of Schedule A to include a "statement informing recipients of Schedule A of their obligations under the Subsequent Transfers reporting rules." *Id.* (pointing out that ACTEC and other commentators have urged the IRS to do that).

Some planners avoid the "implied tax advice" issue by having the personal representative send the transmittal letter to beneficiaries (indeed, it is the executor that has the legal obligation to send the Schedule(s) A to beneficiaries).

(12) **Mechanics of Processing Form 8971 and Schedule(s) A.** The mechanics of completing the Form 8971 (particularly the date that the Schedule(s) A are "provided" to beneficiaries), mailing Schedule(s) A, having the Form 8971 signed by the personal representative and tax preparer, and mailing the Form 8971 can become rather complicated. The easiest approach is to have the personal representative come to the tax preparer's office to accomplish all of these steps at the same time. Otherwise, various steps are needed. Mickey Davis and Melissa Willms (Houston, Texas) describe the procedures that they use:

> If the PR isn't going to come to the office to sign the letter and 8971 so that we can complete the date for providing the Schedule(s) A and get them sent the same day, we send it all as a packet to the PR with instructions to sign the 8971, fill in the date for providing the Schedule A to each beneficiary, and mail the Schedule(s) A by certified mail to the beneficiaries the same date the date is filled in! Then, we have the PR send the original 8971 back to us so the attorney can sign the 8971 and send it all to the IRS, again by certified mail. When sending the packet to the IRS, we enclose a duplicate copy of the filing letter and the 8971 (without schedules) to be file-stamped and returned. (Grrr, it just irritates me thinking about how silly and complicated it is!)
>
> We're also fine if the PR wants to just sign the 8971 and have us fill in the providing date once the original 8971 gets back to us. He/she just has to tell us the date(s) the Schedule(s) A were mailed by certified mail to the beneficiaries!
>
> Also, when we have more than one PR we do make all of them sign – we just have a separate signature page for each.

(13) **Power of Attorney**. The executor may sign a Form 2848, Power of Attorney and Declaration of Representative if the executor wants the preparer to represent the estate before the IRS with respect to the Form 8971 and Schedule(s) A. The September 2016 Instructions to Form 8971 add several details (some are surprising!) about completing the Form 2848.

> When completing Form 2848, remember the executor, not the estate, is the "taxpayer" to be listed in line 1 [despite a statement in the preceding paragraph of the Instructions that the preparer is representing "the estate" with respect to the Form 8971 and Schedules A], and the TIN listed should also be the executor's TIN. Also, when filling out line 3, enter "Civil Penalties" [Observation: YIKES!!!] in the Description of the Matter column, "Form 8971/Schedule A" in the Tax Form Number column, and the decedent's date of death using the four-digit year and two-digit month as YYYYMM" in the Year(s) or Period(s) column.

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

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

a. **Overview of IRS Priority Guidance Plan.** Four new items were added on the Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015

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

Items 3, 5, and 8 all relate to sales to grantor trusts, suggesting that issues related to sales to grantor trusts are major "radar screen" issues for the IRS. These issues are discussed further in Items 4.b, 4.c, 4.d, and 4.e of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

The 2016-2017 Priority Guidance Plan was published August 15, 2016. It includes two new items:

> "2. Guidance on definition of income for spousal support trusts under §682. [This projects addresses whether references to income in §682 refers to taxable income or fiduciary accounting income.]
>
> …
>
> 10. Guidance under §§2522 and 2055 regarding the tax impact of certain irregularities in the administration of split-interest charitable trusts." [This project will provide guidelines as to irregularities that are merely "foot faults" and those that have more serious consequences (and that may result in disqualification of the trust, under the reasoning of *Estate of Atkinson v. Commissioner*, 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002).]

The 2016-2017 Plan deletes two GST items that had been on the plan for a number of years. For example, these were items 9 and 10 on the 2015-2016 plan:

> "9. Regulations under §2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP [This could include, for example, the allocation of GST exemption to trusts created under a GRAT at the end of the initial GRAT term. This project first appeared on the 2012-2013 plan)].
>
> 10. Final regulations under §2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008. [This item first appeared in the 2007-2008 plan.]"

Other items in the 2016-2017 Priority Guidance Plan carried over from prior years include:

- Final regulations under §2032A regarding imposition of restrictions on estate assets during the six month alternate valuation period (this project first appeared in the 2007-2008 plan and proposed regulations were re-issued in November 2011; these "anti-*Kohler*" regulations are reportedly nearing completion; see Item 4.b.(6) of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.);
- Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against an estate [which could address Graegin loans] (this project first appeared in the 2008-2009 plan, and reportedly proposed regulations will be issued in the near future; see Item 4.b.(5) of the Current Developments and Hot Topics Summary (December 2016) found here **here** and available at **www.Bessemer.com/Advisor**.);
- Regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships (this item first appeared in the 2003-2004 plan) (proposed regulations were released August 2, 2016, discussed in Item 6 below); and
- Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates (this item first appeared in the 2009-2010 plan to implement the provisions of the "HEART Act" of 2008, and proposed regulations were issued on September 10, 2015; work is continuing on this difficult project and final regulations are not expected in the near future).
- Final regulations under §1022 will provide guidance to recipients of property acquired from decedents who died in 2010; there will likely be few changes from the proposed regulations that were issued in May 2015.

The focus of the Trump administration is cutting down on the burden of regulations and reducing complexity and taxpayer burden. The Trump 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. The Treasury is still working with the Office of Management and Budget (OMB) to address how that order applies to transfer tax regulations.

Executive Order 13789, issued on April 21, 2017, directed Treasury to review all "significant tax regulations" issued on or after January 1, 2016 and submit an interim report identifying any such regulations that (i) impose an undue financial burden on taxpayers, (ii) add undue complexity to the tax laws, or (iii) exceed the statutory authority of the IRS, and to submit a final report recommending "specific actions to mitigate the burden imposed by regulations identified in the interim report." In Notice 2017-38, the IRS identified eight proposed, temporary and final regulations that may impose an undue financial burden on taxpayers or add undue complexity to the tax laws, and included the §2704 proposed regulations in that list of eight. The IRS published its Second Report to the President on Identifying and Reducing Tax Regulatory Burdens on October 2, 2017. It recommend withdrawing the two proposed regulations identified in the initial report (including the §2704 proposed regulations) and recommending revoking in part certain regulations and substantially revising other regulations.

The Treasury issued its 2017-2018 Priority Guidance Plan on October 20, 2017, in a somewhat different format than prior years to conform to the directions of Executive Order 13789. It lists only projects that the Treasury hopes to complete prior to June 30, 2018.

- Part 1 addresses the eight regulations identified in the Notice 2017-18, and among other things includes the withdrawal of the §2704 proposed regulations (and those proposed regulations have now been formally withdrawn).
- Part 2 describes certain projects "identified as burden reducing" and includes"[r]egulations under §§1014(f) and 6035 regarding basis consistency between estate and person [sic] acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016." Also included in this category is "Guidance under §301.9100 regarding relief for late regulatory elections
- Part 4 is similar to prior years' plans. The "Gifts and Estates and Trusts" section includes only three items:

  "1. Guidance on basis of grantor trust assets at death under §1014.

  2. Final 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.

  3. Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate."

Dana Trier, deputy assistant secretary for tax policy, has added that the Treasury department "is also looking at some 200 rules identified as outdate….The true number was closer to 300, but 200 was chosen as a more conservative number in an October 2 department report, he said." John Herzfeld, *Treasury Officials a 'Bridge' in Tax Reform,* BNA DAILY TAX REPORT (October. 24, 2017).

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

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

This new procedure has been widely criticized by planners. The IRS responded by describing a procedure by which the taxpayer could obtain an account transcript which would serve the purpose of a closing letter. In early December 2015, the IRS added a webpage entitled "Transcripts in Lieu of Estate Tax Closing Letters" describing the process. Notice 2017-12, dated January 23, 2017, provides guidance on the methods available to confirm the closing of an examination of the estate tax return. The notice states that an account transcript with a transaction code of "421" and explanation "Closed examination of tax return" can serve as the functional equivalent of an estate tax closing letter for third persons.

Some practitioners have had great difficulty in becoming qualified to access and in accessing the account transcript for an estate. Many hours and frustrating phone calls have sometimes still not resulted in being to access the transcript. For a (rather humorous) description of one practitioner's attempts to complete the 17-step process of registering on the IRS's TDS system to request account transcripts online, see Item 2.g.(2) of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**. Similar problems or long periods of no response after requesting a transcript have been reported by various practitioners. Indeed, one planner was told by an IRS representative in the Spring of 2017, after inquiring about a very long wait for a transcript, that the procedure was not operational and that the planner should send a fax requesting a closing letter, essentially advising to ignore the new procedures in full. (The closing letter was received shortly after sending the request.) IRS officials are still encouraging practitioners to use the transcript system, however.

c. **Qualified Contingencies in Charitable Remainder Trusts, Rev. Proc. 2016-42.** Rev. Proc. 2016-42 addressed this item, providing a way for a CRAT to satisfy the difficult "probability of exhaustion" test by terminating before making an annuity payment that would cause it to fail the test, as discussed in Item 4.b.(4) of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

d. **Using QTIP Trusts With Portability, Rev. Proc. 2016-49**. Rev. Proc. 2016-49 was issued September 27, 2016 to modify and supersede Rev. Proc. 2001-38 and clarify that portability can be used in connection with QTIP trusts. Rev. Proc. 2001-38 was intended to provide relief to estates that inadvertently made the QTIP election at the first spouse's death when the election was not needed to reduce the estate tax. The new revenue procedure explains that with the amendment to the Code allowing portability elections, a deceased spouse's estate may wish to elect QTIP treatment for property even when not necessary to reduce the estate tax lability, in order to leave a greater DSUE amount that could be utilized by the surviving spouse. The new procedure requires an affirmative election by the taxpayer seeking to nullify the QTIP election and generally treats a QTIP election as void only if (i) the federal estate tax was zero regardless of the QTIP election, (ii) no portability election was made, and (iii) the taxpayer follows specified procedural requirements to treat the QTIP election as void. For a discussion of the details of this procedure see Item 16.b below.

e. **Section 6166 Guidance**. The IRS has been working on new comprehensive proposed regulations under §6166. A primary issue is the requirement of security in making a §6166 election, but the existing regulations will be restated and replaced with new regulations.

f. **Inflation Adjustments for 2016, 2017.** Revenue Procedures 2016-55 and 2017-58 describe inflation adjustments for 2017 and 2018, respectively. Some of the adjusted figures include the following:

- Individual income tax brackets: The top bracket for married individuals begins at $470,700 of taxable income in 2017 and $480,050 in 2018; the top bracket for single individuals begins at $418,400 of taxable income in 2017 and $426,700 in 2017;
- Estate and trust income tax brackets: The top bracket begins at $12,400 of taxable income in 2016, $12,500 in 2017, and $12,700 in 2018,;
- Transfer tax exemption amount: The basic exclusion amount (i.e., the estate, gift, and GST "exemption" amount) is $5,450,000 in 2016, $5,490,000 in 2017, and $5,600,000 million in 2018);
- Annual exclusion: The gift tax annual exclusion has been at $14,000 since 2013 but will increase to $15,000 in 2018 (the annual exclusion number is 1/10th of the indexed number for the non-citizen spouse gift amount, described immediately below, increasing only in increments of $1,000 without "rounding up"); and
- Gifts to non-citizen spouse: The first $149,000 of present interest gifts in 2017 and $152,000 in 2017 to a non-citizen spouse are excluded from taxable gifts.

g. **GST Trust Modification Rulings Suspended But Now Resumed**. Cathy Hughes (with the Treasury Department) has announced beginning in the fall of 2016 that the IRS temporarily suspended considering GST rulings for trust modifications until further notice. This was not added to the "no-rule" list in Rev. Proc. 2017-3 because it was not a permanent change. The reason for this change was that the IRS does not have sufficient resources to continue considering these requests, which are often accompanied by a huge stack of documents. Requests that were filed before this change of policy were still considered; future submitted requests would be returned.

Government officials have informally indicated (in June 2017) that the temporary suspension of GST trust modification rulings has now been lifted, and the IRS will again entertain these ruling requests.

h. **Same-Sex Marriage; Notice 2017-15 Allowing Recovery of Applicable Exclusion Amount and GST Exemption Allocation**. Rev. Rul. 2013-17 clarified that for federal tax purposes (1) terms relating to marriage include same-sex couples, (2) a place of celebration standard is applied if a same-sex couple moves that a state that does not recognize same-sex marriages, and (3) the ruling does not apply to domestic partnerships or civil unions. It is applied prospectively as of September 16, 2013 (the date of the ruling's publication) but taxpayers may (but need not) file back returns within the standard limitations period for refunds if the recognition of the marriage results in lower taxes. In effect, the IRS implicitly acknowledged the retroactive application of unconstitutionality of the Federal Defense of Marriage Act ("DOMA"). *See also* Treas. Reg. §301.7701-18 (definition of "husband and wife" as meaning "two individuals lawfully married to each other").

While Rev. Rul. 2013-17 allows a refund for open years, it does not address whether, for closed years when a refund is not allowed, an individual's use of unified credit can be restored for purposes of subsequent gifts or for estate tax purposes at the individual's death. Regulation §25.2504-2(b) provides that if the statute of limitations has run on a gift tax return, the amount of the taxable gift resulting from that return, for purposes of determining the taxable gifts in prior periods when calculating later gift taxes, can never be re-determined. That applies to all issues relating to the gift including "the interpretation of the gift tax law." The constitutionality of that approach has been question, however, with respect to same-sex marriage issues in light of finding in *U.S. v. Windsor* [133 S. Ct. 2675 (2013)] that §3 of DOMA is unconstitutional.

Notice 2017-15 now clarifies that an individual who made a gift to a same-sex spouse that should have qualified for marital deduction, but for which the statute of limitations has run on obtaining a refund of the gift tax paid, may recalculate the remaining applicable exclusion amount as a result of recognizing the individual's marriage to his or her spouse. The Notice describes various procedures and limitations.

- Once the period of limitations has expired, neither the value of the transferred interest nor any position concerning any legal issue (other than the existence of the marriage) can be changed.

- The "taxpayer must recalculate the remaining applicable exclusion amount, in accordance with IRS forms and instructions [to be provided] on a Form 709 (preferably the first Form 709 required to be filed by the taxpayer after the issuance of this notice), on an amended Form 709 (if the limitations period under §6511 has not expired), or on the Form 706 for the taxpayer's estate if not reported on a Form 709."
- An amended or supplemental return need not be filed merely to report an increased applicable exclusion amount unless the taxpayer has predeceased the notice (i.e., died before January 17, 2017).
- Mechanics: (1) The taxpayer should add "FILED PURSUANT TO NOTICE 2017-15" at the top of the Form 709 or Form 706 that is filed to recover the applicable exclusion amount; and (2) A statement must be attached supporting the claim for the marital deduction and detailing the recalculation of the remaining applicable exclusion amount.
- If a QTIP or QDOT election is required to obtain the marital deduction, a separate request for relief pursuant to Reg. §301.9100-3 must be submitted.
- The notice does not extend the applicable time limits on making the split gift election under §2513.
- Any unrefunded gift tax paid, for which the period of limitations has expired, "will continue to be recognized as gift tax paid or payable for purposes of the computation of the estate tax under §2001." For a discussion of the effect of this provision, see George Karibjanian, *In Keeping with the Times, Treasury Goes "Retro" in IRS Notice 2017-15 for Same-Sex Marriage and Certain Transfer Tax Exemptions*, LEIMBERG ESTATE PLANNING NEWSLETTER #2514 (February 17, 2017) (suggesting that the gift to the spouse should not be added to the estate tax calculation as an adjusted taxable gift [because of the marital deduction that should have been allowed] on line 4 of Form 706, and therefore no amount is subtracted for the gift tax that would have been payable with respect to such gift on line 7 of Form 706, but the full unified credit is allowed as a credit against the estate tax on line 9d of Form 706; in effect, no specific credit is given for the prior gift tax paid, but the calculation often ends up with the individual paying less overall gift and estate tax than if the applicable exclusion amount had not been restored).
- IRS staff persons have indicated informally that taxpayers should not attempt to make this calculation before the IRS has released additional guidance and worksheets to clarify how the adjustment will be made.

If GST exemption was allocated to prior transfers because of the failure to recognize the marriage of the same-sex couple (for example, if the age assignment rules result in a GST transfer that would not have occurred if the spousal relationship had been recognized), the GST exemption will be restored using procedures similar to those described above for recovery of applicable exclusion amount.

i. **Relief Procedure for Extension of Time to File Returns to Elect Portability, Rev. Proc. 2017-34.** Section 2010(c)(5)(A) requires that the portability election be made on an estate tax return for the decedent whose unused exclusion amount is being made available to the surviving spouse. Rev. Proc. 2014-18 allowed a relief procedure for certain estates through December 31, 2014 and Rev. Proc. 2017-34 provides a relief procedure through the later of January 2, 2018 or the second anniversary of the decedent's date of death in certain cases if the estate was not otherwise required to file an estate tax return. See Item 16.d below.

j. **Report from Treasury Inspector General For Tax Administration Regarding Estate and Gift Tax Return Examination Process**. The Treasury Inspector General for Tax Administration (TIGTA) released a report on September 26, 2017 titled "Improvements Are Needed in the Estate and Gift Tax Return Examination Process" (Reference Number: 2017-30-081). The report reviewed the audit processing of estate and gift tax returns during Fiscal Year 2016. The report included the following conclusion:

> TIGTA 's review of the classification, prioritization, and inventory assignment processes identified improvements that are needed in the Internal Review Manual (IRM) guidance, classification sheet documentation, and managerial oversight. TIGTA found that:
>
> - There is minimal IRM guidance for case classification, prioritization, and inventory assignment processes.
> - Some classification sheets, when filled out by classifiers, are difficult to read or are incomplete.
> - A single employee prioritizes cases selected for examination during classification sessions and assigns these cases to the field for examination, and a lack of documented managerial reviews over the processes poses risks.
>
> Also, case documentation guidelines were not followed in 18 (47 percent) of 38 randomly sampled estate tax examinations and in 17 (46 percent) of 37 randomly sampled gift tax examinations.
>
> …
>
> TIGTA made several recommendations to improve the examination of estate and gift tax returns, including the creation of a legible classification sheet; revisions to the IRM; strengthening of internal controls; and develop guidance on the circumstances in which it is advisable to propose and issue inconsistent notices of deficiency in estate and gift tax examinations.
>
> In response to the report, IRS officials agreed with the recommendations and plan to take appropriate corrective actions.

6. Section 2704 Proposed Regulations

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

Beginning with the 2003-2004 Treasury/IRS priority guidance plan, the plans have had a project for guidance/regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships.

The IRS on August 2, 2016 released long-awaited proposed regulations under §2704 (published in the Federal Register on August 4, 2016).

b. **Detailed Discussion of Proposed Regulations**. For a detailed discussion of the substantive provisions of the proposed regulations, see Item 5.c-l of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

c. **Withdrawal of the Proposed Regulations**.

The proposed regulations spawned a firestorm of responses.

Executive Order 13789, issued on April 21, 2017, directed Treasury to review all "significant tax regulations" issued on or after January 1, 2016 and submit an interim report identifying any such regulations that (i) impose an undue financial burden on taxpayers, (ii) add undue complexity to the tax laws, or (iii) exceed the statutory authority of the IRS, and to submit a final report recommending "specific actions to mitigate the burden imposed by regulations identified in the interim report." In Notice 2017-38, the IRS identified eight proposed, temporary and final regulations that may impose an undue financial burden on taxpayers or add undue complexity to the tax laws, and included the §2704 proposed regulations in that list of eight.

The Executive Order also instructed that a final report be submitted to the President by September 18, 2017 "recommending specific actions to mitigate the burden imposed by regulations identified in the interim report." The IRS published its Second Report to the President on Identifying and Reducing Tax Regulatory Burdens on October 2, 2017. It recommended withdrawing the two proposed regulations identified in the initial report (including the §2704 proposed regulations) and recommended revoking in part certain regulations and substantially revising other regulations. That the IRS recommended withdrawing the §2704 proposed regulations was no surprise, but the language used to strongly criticize and almost make fun of the prior proposed regulations was quite surprising.

The Report stated, in part, as follows:

> The proposed regulations, through a web of dense rules and definitions, would have narrowed long-standing exemptions and dramatically expanded the class of restrictions that are disregarded under Section 2704. In addition, the proposed regulations would have required an entity interest to be valued as if disregarded restrictions did not exist, either in the entity's governing documents or under state law. No exceptions would have been allowed for interests in active or operating businesses.
>
> …
>
> ….. Commenters warned, however, that the valuation requirements of the proposed regulations were unclear and that their effect on traditional valuation discounts was uncertain. In particular, commenters argued that it was not feasible to value an entity interest as if no restrictions on withdrawal or liquidation existed in either the entity's governing documents or state law. …
>
> After reviewing these comments, Treasury and the IRS now believe that the proposed regulations' approach to the problem of artificial valuation discounts is unworkable. In particular, Treasury and the IRS currently agree with commenters that taxpayers, their advisors, the IRS, and the courts would not, as a practical matter, be able to determine the value of an entity based on the fanciful assumption of a world where no legal authority exists. Given that uncertainty, it is unclear whether the valuation rules of the proposed regulations would have even succeeded in curtailing artificial valuation discounts. Moreover, merely to reach the conclusion that an entity interest should be valued as if restrictions did not exist, the proposed regulations would have compelled taxpayers to master lengthy and difficult rules on family control and the rights of interest holders. The burden of

> compliance with the proposed regulations would have been excessive, given the uncertainty of any policy gains. Finally, the proposed regulations could have affected the valuation discounts even where discount factors, such as lack of control or lack of a market, were not created artificially as a value-depressing device.
>
> In light of these concerns, Treasury and the IRS currently believe that these proposed regulations should be withdrawn in their entirety. Treasury and the IRS plan to publish a withdrawal of the proposed regulation shortly in the Federal Register.

Referring to the proposed regulation as applying "fanciful assumptions" is startling. Ron Aucutt has also commented on the "harsh tone" used in the Report. He suggests that Report's description (not attributed to commenters) of the proposed regulations as "a web of dense rules and definitions [that] would have narrowed longstanding exceptions and dramatically expanded the class of restrictions that are disregarded under Section 2704" was a gratuitous statement suggesting "that political influences, and possibly political appointees, played a greater-than-usual role in the content and tone of the report on this issue." Matthew Madara, *Treasury Will Withdraw Controversial Estate Tax Valuation Regs*, TAX NOTES (Oct. 5, 2017). *See also* Ronald Aucutt, *Proposed Section 2704 Regulations To Be Withdrawn*, ACTEC Capital Letter No. 42 (October 6, 2017).

The proposed regulations have now been formally withdrawn. REG-163113-02, FR Doc. 2017-22776, filed 10/17/2017 for publication 10/20/17.

7. Placebo Planning – Dispelling Common Transfer Planning Myths

Professor Jeff Pennell (Atlanta, Georgia) discussed some of the mathematics of transfer planning concepts, dispelling some commonly held myths.

a. **Saving Tax on the Appreciation.** And often stated maxim of the advantage of the estate freezing is that "any future appreciation will not be includable in the estate." That maxim is incorrect to the extent that it suggests that an advantage results from paying an upfront tax in order to avoid estate tax on the appreciation. With a flat tax, whether the transfer tax is incurred currently at a low value or later at a higher value makes no difference.

b. **Savings From Grantor Paying Income Tax on Grantor Trust**. The grantor's payment of income tax on grantor trust income, without that payment being treated as a gift, is often stated as a key advantage of grantor trusts. That factor alone, however, is not significant. For example, the donor can give $2,000 to a trust, which produces $100 annually. The donor's income tax on that $100 is $40. The trust receives $100 free of income tax and the donor pays $40 of income tax. Alternatively, the donor could keep the $2,000 of income-producing corpus and receive the $100 each year, paying the $40 of income tax, and giving $100 to the donee. In each case, the donee receives $100 income tax-free, and the donor pays $40 of income tax.

   In reality, a gift of corpus to the trust involves a gift of the income interest and remainder interest. If the valuation of the income interest is accurate, over time whether the income is given all at once, up front, or piecemeal over time should make no difference. However, if the gift of the income interest is leveraged because the valuation is not accurate, an advantage could result.

c. **Advantage of Using Gift Exemption (a "Frozen Asset")**. A gift of income-producing property may be offset by the use of the unified credit to avoid gift tax on creation. In effect, the donor is using a "cold" asset (unified credit) in order to shift an appreciating (or income-producing) asset. Making gifts or sales without paying gift taxes allows a tax-efficient way to make use of transferring future appreciation and transferring future income on an income tax-free basis. Jeff's conclusion: "The unified credit is a frozen value asset that is used to shift future appreciation in the underlying corpus. The source of the real benefit is using an asset that will not grow in value (the unified credit) to pay the tax on an asset that will grow in value, without incurring wealth transfer tax in the future. That benefit must be weighed against the loss of the basis at death."

d. **Using "Cold" Assets to Shelter the Appreciation on "Hot" Assets**. If an estate consists of cash (or other non-growth) assets and appreciating assets, using the "cold" assets to prepay the tax, in order to insulate appreciation on the hot assets from being subject to tax, is the primary tax advantage of gifting strategies. As discussed above, one type of "cold" asset is the use of the unified credit currently to shift the appreciation from "hot" assets.

   Another example of this phenomenon is using non-IRA assets to pay the income tax on converting an IRA to a Roth IRA.

e. **Credit Shelter Trust vs. Portability at First Spouse's Death**. Three scenarios are compared for planning alternatives at the first spouse's death: (1) portability, (2) optimal marital/credit shelter trust, and (3) attempting equalization by accelerating tax at the first death. Examples show that if assets values do not change between the spouses' deaths, all three approaches generate the same result. If the assets increase in value, the portability plan is not as effective as the other two scenarios. If assets depreciate during the "over life" of the surviving spouse, the portability alternative is better.

f. **Allocation of Exemption in a Carryover Basis World.** If the estate tax is repealed with carryover basis, and if some amount of exemption can be added to the basis of assets at the election of the estate, how should the exemption be allocated? Jeff concludes that the exemption should be allocated to assets that are intended to be sold first. An exception is if assets are subject to depreciation, deduction, or depletion. Allocating basis to those assets permits a new round of current depreciation/depletion deductions (against ordinary income tax). An even better result occurs for assets that would also be subject to recapture.

   In a carryover basis world, life insurance may be a favored investment (assuming that the internal build-up in value is not subject to income tax during life and that death proceeds are not subject to income tax at death).

8. Structuring Trusts For Flexibility

Much of this discussion in this Item comes from a panel discussion at the 2017 Heckerling Institute by Steve Trytten, Jonathan Blattmachr, Mickey Davis, and Steve Gorin (based on the work of an ongoing ACTEC Task Force). The form clauses included below are taken from those materials. The extensive detailed materials contain samples of irrevocable trusts and outstanding detailed forms dealing with a wide variety of issues including things such as –

- supplemental needs trust,
- substance abuse,
- decanting,
- trustee appointment and succession,
- trust protector powers,
- release of protected health information to trust protector,
- directed trust and divided trusteeship (with detailed powers of an investment trustee and powers of a distributions trustee),
- savings clause negating power of appointment for interested trustee as beneficiary,
- maintenance of real or personal property and permitting beneficiaries to use such property,
- apportionment of receipts and disbursements,
- S corporation stock,
- closely held business interests,
- farm or ranch property,
- Crummey withdrawal rights,
- authority to make charitable distributions,
- grantor trust trigger powers (including substitution power and power to compel trustee to loan without adequate security),
- retirement benefits provisions (including conduit trusts and accumulation trusts),
- changing situs and governing law,
- powers of appointment (including formula general powers of appointment and exercise of powers to "trigger" the Delaware tax trap),
- unitrust distributions, and
- treating capital gain as part of DNI.

a. **Flexibility to Distribute Income to Charity.** For an excellent discussion of charitable contributions by trusts or estates, see Jonathan Blattmachr, F. Ladson Boyle & Richard Fox, *Planning for Charitable Contributions by Estates and Trusts,* 44 EST. PL. (Jan. 2017). Authorizing discretionary charitable distributions can provide very helpful flexibility.

(1) **Advantages.** The ability of a trust to make charitable contributions has several distinct advantages compared to individual charitable contributions. (i) Trusts do not have percentage limitations on the charitable deduction, but §642(c) allows an unlimited deduction. (However, the percentage limitations under §170 apply to a trust

to the extent the gross income that is paid to charity consists of unrelated business income. The trust should direct that payments come first from gross income that is not unrelated business income, though it is not clear that restriction would be respected for tax purposes.) (ii) A trust is entitled to a charitable deduction for the year in which the income is paid for charitable purpose even if the income was earned in prior years. (iii) If a payment of gross income to charity is made in the year after it is earned, the trust may elect under §642(c)(1) to treat the payment as having been made in the preceding year in which the gross income was earned. (iv) A trust (unlike individuals) can reduce its net investment income subject to the 3.8% tax by charitable deductions. (v) The cut-back on deductions under §68 does not apply to estates or trusts. (vi) If future legislation imposes overall monetary limits on deductions (as proposed by President Trump), those same limitations may not be imposed on trusts.

(2) **Requirements For Charitable Deduction**. A trust (or estate) receives a charitable deduction under §642(c) if (i) the payment is from gross income, (ii) made pursuant to the terms of a governing instrument, and (iii) for a purpose specified in §170(c) (i.e., for a charitable purpose).

Gross Income. Cases have varied in determining the extent to which the payment to charity must be traced directly to gross income actually received by the trust. A rather surprising 2015 case held that a trust was entitled to a deduction for the full fair market value of appreciated property (rather than just the basis of such property) that is contributed to charity, where the properties were bought with proceeds of gross income of the trust in prior years. *Green v. United States*, 116 AFTR 2d 2015-6668 (W.D. Okla. 2015). If the trust instrument permits (or in the future may permit) charitable distributions, considering adding that accumulated income will be maintained in a separate accumulated income account (to facilitate establishing that the future distribution is from gross income).

Pursuant to the Governing Instrument. A number of cases have emphasized that no deduction is allowed if the payment to charity is not authorized in the trust agreement. *E.g.*, *Hubbell Trust v. Commissioner,* T.C. Summ. Op. 2016-67 (even though probate court ruled that language of a will authorized charitable distributions, Tax Court ruled that no ambiguity existed that could authorize the trustee to make charitable contributions). A payment to charity pursuant to the exercise of a power of appointment should satisfy this requirement (but see *Brownstone v. U.S.*, 465 F.3d 525 (2nd Cir. 2006)).

If the trust does not authorize chartable distributions, consider (i) decanting the asset to another trust that grants a power of appointment to someone to appoint assets to charity (but whether that is effective is not clear because the charitable intent might arguably have to come from the creator of the original trust), or (ii) contributing assets to a partnership which in turn makes contributions to charity from its gross income. *See* Rev. Rul. 2004-5; Jonathan Blattmachr, F. Ladson Boyle & Richard Fox, *Planning for Charitable Contributions by Estates and Trusts,* 44 EST. PL. (Jan. 2017).

Discretionary Payments Sufficient. The trust does not have to provide for a mandatory distribution; authorized discretionary distributions to charity qualify for the deduction.

(3) **Trustee or Beneficiaries Could Authorize Payment; Checks and Balances; Restrictions**. The trust instrument could authorize the trustee, beneficiaries or others to direct the payments to charity. The trust could structure checks and balances; for example trustees might have to obtain beneficiary consent to charitable distributions, or a trustee or other third party might be required to consent to the exercise of a power of appointment in favor of a charity. Depending on the trust purposes, charitable distributions might be restricted during certain times (for example, until the beneficiary reaches a certain age).

(4) **Sample Clause Authorizing Trustee to Distribute Income to Charity**.

> The Trustee may distribute from the gross income of the trust for a purpose specified in Code Section 170(c) (defining charitable contributions) such amounts as the Trustee determines to be appropriate, taking into consideration the charitable objectives of the grantor[s] and the Beneficiary, as well as the possible income and transfer tax effects of any such distribution; provided, however, that (i) the Trustee shall notify the Beneficiary of the proposed distribution or distributions not less than 30 days prior thereto; and (ii) the Beneficiary shall have an absolute right to veto any such distributions, by providing written notice thereof to the Trustee within 20 days after receiving such notice. If the Beneficiary is Incapacitated, such notice shall be given to the Beneficiary's guardian or other similar representative and the guardian or other similar representative shall have the veto right described above. (Clause provided by Mickey Davis)

(5) **Sample Clause Granting Beneficiary Power to Appoint Income to Charity**.

> The beneficiary, in the beneficiary's individual capacity, shall have the continuing discretionary power to Appoint all or any part of the gross income, as such term is used in Code section 642(c) and the regulations and pronouncements thereunder, to one or more Charities; however, no interest in a Benefit Plan or that Benefit Plan's proceeds may be Appointed in a manner that would change the identity of the individual whose life expectancy would otherwise apply under the Minimum Distribution Rules. The beneficiary may authorize his or her agent to exercise this power to Appoint. (Clause provided by Steve Gorin.)

b. **Discretionary Distributions**. Generally avoid mandatory distributions unless required for some tax purpose. Discretionary distributions afford significantly more flexibility, including greater creditor protection for beneficiaries. Authorize the trustee to allow beneficiaries to use assets. Even for a Marital Trust, Steve Gorin suggests the following: "The trustee shall distribute all of the income of the Marital Trust from and after my death to or **for the benefit of** my spouse, not less frequently than annually, for and during the remainder of my spouse's life." *See* Reg. §§ 20.2056(b)-7(d)(2), 20.2056(b)-5(f).

c. **Apportionment of Receipts and Disbursements**. Authorize the trustee to allocate receipts and disbursements between income and principal in a reasonable manner in the trustee's discretion.

> The Trustee is authorized to determine what is principal and income of the trust estate and what items shall be charged or credited to either. In making these determinations, the Trustee shall act reasonably and treat the beneficiaries impartially consistent with the Trustee's fiduciary duties, and the Trustee may not exercise these powers in any way that departs fundamentally from traditional principles of income and principal within the meaning of Treasury Regulations 1.643(b)-1. No inference of imprudence or partiality shall arise solely because the Trustee exercises the Trustee's discretion to determine what is principal and income in a manner that deviates from default rules of law that arbitrarily allocate fixed percentages of receipts to principal and income. (Clause by Steve Trytten)

d. **Unitrust Definition of Income.** For instruments that require mandatory income distributions (such as QTIP trusts), consider using a unitrust definition of income.

With that approach all beneficiaries have an interest in the trust investing in a manner that will maximize the security and growth of the trust. Consider the following with a unitrust clause:

- use a two or three-year rolling average so that valuation swings will not disrupt distributions dramatically;
- discuss how to value hard-to-value assets; and
- if the trustee allows a beneficiary to use residential property, provide that the value of the residence shall be excluded in determining the unitrust amount. (The beneficiary's rent-free use of the property is not income to the beneficiary, as discussed immediately below.)

e. **Use of Trust Property by Beneficiary.** 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.

Sample Clause:

> **Acquisition and Maintenance of Real Property.** The Trustee may acquire, hold and maintain any residence (whether held as real property, condominium or cooperative apartment) for the use and benefit of any one or more of the beneficiaries of any trust whenever that action is consistent with the terms of that trust, and, if the Trustee shall determine that it would be in the best interests of the beneficiaries of that trust (and consistent with the terms of that trust) to maintain a residence for their use but that the residence owned by that trust should not be used for such purposes, the Trustee may sell said residence and apply the net proceeds of sale to the purchase of such other residence or make such other arrangements as the Trustee shall deem suitable for that purpose. Any proceeds of sale not needed for reinvestment in a residence as provided above shall be added to the principal of that trust and thereafter held, administered and disposed of as a part thereof. The Trustee may pay all carrying charges of such residence, including, but not limited to, any taxes, assessments and maintenance thereon, and all expenses of the repair and operation thereof, including the employment of household employees (including independent contractors) and other expenses incident to the running of a household for the benefit of the beneficiaries of that trust. Without limiting the foregoing, the Trustee may permit any income beneficiary of any trust created hereunder to occupy any real property or use any personal property forming a part of that trust on such terms as the Trustee may determine, whether rent free or in consideration of payment of taxes, insurance, maintenance and ordinary repairs or otherwise. In the case of any trust created under this Agreement that qualifies for the marital deduction, such occupancy shall be rent free and any other condition shall be consistent with the intention that the Grantor's Wife have that degree of beneficial enjoyment of the trust property during life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust, so that the Grantor's Wife's interest is a qualifying income interest for life for purposes of the marital deduction. (Clause by Jonathan Blattmachr.)

f. **Trustee Compensation**. To the extent consistent with the client's intent, avoid any blanket prohibition on trustee compensation. A family member who might otherwise waive trustees' fees might appreciate the flexibility to receive fees in a manner that reduces the net income tax to the family. (For example, trustee compensation reduces net investment income subject to the 3.8% tax.) However, a trustee may have a limited time period to waive fees without income or gift tax consequences. Rev. Rul. 660167 (6-month safe harbor); *Breidert v. Commissioner*, 50 T.C. 844, 848 (1968).

Sample Clause:

(a) Individual Trustee. An individual trustee, other than my spouse or me while I am living, is entitled to receive compensation out of the assets of the trust estate. The amount of the individual's compensation shall be reasonable in view of the time required of the individual, the nature and value of the assets in the trust estate and the amount of compensation provided for comparable services for comparable trusts in the market where the trust is situated, under the published fee schedules of corporate trustees in effect at the time the individual trustee's services are rendered.

(b) Corporate Trustee. A corporate trustee shall receive such compensation for its services as trustee as provided for in its published schedule of fees in effect at the time such services are rendered, or such lesser amount as it may, from time to time, agree. Anything herein to the contrary notwithstanding, no corporate trustee shall be entitled to a termination fee, a distribution fee, or a fee resulting from the resignation or removal of such corporate trustee.

(c) Any Trustee. Any trustee may waive its compensation, either expressly or by implication, in whole or in part. Any trustee, whether individual or corporate, is entitled to be reimbursed for such expenses as may be incurred by the trustee in connection with the administration of the trust. (Clause by Steve Gorin)

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

(i) the grantor pays the income taxes on the trust income so the trust can grow faster, and the tax payments further reduce the grantor's taxable estate without generating any transfer tax liability;

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

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

Ways to build flexibility into a grantor trust include (i) giving the grantor the ability to end the grantor trust status when desired and (ii) making distributions to the grantor's spouse to pay the income taxes, if desired (assuming the spouse is a discretionary beneficiary).

h. **Grantor Trust – Trigger Powers, Generally.** Various trigger powers can be used to cause grantor trust status. The most commonly used is a non-fiduciary right to substitute assets for equivalent value. Another is the power to make loans to the grantor without adequate security. (This trigger power could also be engaged by authorizing a non-adverse party to give the grantor the power to borrow without adequate security.)

The grantor will probably feel most comfortable using a trigger power that is in the grantor's control (so the grantor can relinquish the power and "turn off" grantor trust status when desired).

i. **Grantor Trust – Substitution Power.** "A power to reacquire the trust corpus by substituting other property of an equivalent value" that is held in a non-fiduciary capacity will cause the trust to be a grantor trust as to corpus and income. §675(4)(C); Reg. §1.671-3(b)(3). Following the issuance of Rev. Rul. 2008-22 and Rev. Rul. 2011-28 confirming that a grantor's non-fiduciary "swap" power generally will not cause estate inclusion under §2036, 2038, or 2042, substitution powers are the most commonly used trigger power to cause a trust to be a grantor trust. The power can be held by the grantor or a third party.

Some planners prefer using a third-party substitution power for a trust that holds voting stock of a controlled corporation under §2036(b) because, while Rev. Rul. 2008-22 negates inclusion under §2036, the reasoning of the ruling does not specifically address §2036(b). Nevertheless, IRS officials have indicated informally that no consideration was given to issuing a ruling similar to Rev. Rul. 2011-28 regarding §2036(b) specifically because Rev. Rul. 2008-22 covers §2036. Those potential concerns regarding closely held stock can be avoided by transferring non-voting stock.

While substitution powers do not create estate inclusion risks, consider whether a creditor of a power holder might be able to step into the shoes of the power holder and exercise the substitution power to acquire a favored asset. To minimize that risk for a power holder with potential creditor issues, consider adding a requirement that some non-adverse, non-fiduciary party must consent to the exercise of the substitution power. *See* Edwin Morrow, *Ed Morrow and the Dark Side to Swap Powers in Irrevocable Grantor Trusts*, LEIMBERG ASSET PROTECTION PLANNING EMAIL NEWSLETTER #313 (Feb. 3, 2016).

***Sample Swap Power Clause for a Single Grantor*:**

> Notwithstanding any contrary provision, I may reacquire any of my grantor property from any trust created under this instrument by substituting other property of an equivalent value. For purposes of the preceding, my "grantor property" means the property (or portion of property) with respect to which I am the grantor for federal income tax purposes. I may irrevocably release this power in whole or in part by notice to the Trustee. I may exercise (or release) this power: (i) in a non-fiduciary capacity and without the consent of any person; and (ii) through a duly appointed guardian or a duly authorized attorney-in-fact. I hold this power in a non-fiduciary capacity, and may exercise it without the approval or consent of the Trustee or any other person. However, the Trustee, acting in a fiduciary capacity shall have a duty to ensure that the property substituted has equivalent value, and to that end, shall provide me with sufficient information regarding the assets of the trust to enable a suitable valuation of the assets to be performed. I intend that the trusts created under this instrument constitute "grantor trusts" for income tax purposes under the Code whenever (and to the extent that) this power exists but not otherwise; this instrument shall be administered and interpreted in a manner consistent with this intent and any provision which conflicts with this intent shall be deemed ambiguous and shall be construed, amplified, reconciled, or ignored as needed to achieve this intent. (Clause by Mickey Davis.)

j. **Grantor Trust – "Turning Off" Grantor Trust Status; Toggling**. Being able to "turn off" the grantor trust status when the grantor no longer wishes to pay income taxes on the trust income can be an important factor in the grantor being willing to create a trust that would initially be treated as a grantor trust. Furthermore, planning flexibility could be increased if the power to "toggle" grantor trust status could be achieved.

Notice 2007-73 identifies certain "toggling" grantor trusts as transactions of interest. That noticed addresses two complicated scenarios, the goal of which is either to generate a tax loss to the grantor that is not a real economic loss or to avoid the recognition of gain. The Notice does not appear to apply to "garden variety" grantor trusts (even though grantor trust status has been toggled). The Notice states explicitly that merely terminating grantor trust status does not invoke the Notice.

General guidelines for maximizing flexibility include the following:

1. whoever has a substitution power should be given the authority to release the power and bind future persons (thereby terminating grantor trust status permanently, if desired);
2. if the grantor holds the trigger power, the grantor can be given the ability to relinquish the power (to the extent provided in the trust agreement) and therefore terminate grantor trust status;
3. an agent for the grantor under a power of attorney should have the authority to relinquish the trigger power;
4. consider using a temporary release of the power such as, for example, giving up the swap power during 2017 (the relinquishment would apply prospectively and not back to the beginning of the year); that approach would cause the trust to again become a grantor trust in 2018, unless the swap power is released again;
5. use different persons to have the right to relinquish or reacquire the power;
6. an adverse or non-adverse party could hold the power to relinquish and reinstate the grantor trust power (but note that if the grantor's spouse has the power to relinquish and to reacquire the grantor trust power, the grantor would be treated as holding the power to reacquire the grantor trust power [under §672(e)] and grantor trust status arguably would not be cut off by relinquishment of the power causing grantor trust status);
7. giving different persons the authority to exercise those powers, to relinquish them, or to reacquire them, may provide useful checks and balances of the ability to misuse those powers;
8. the relinquishment of the grantor trust power should address whether it binds successors, and in any event only permit reinstatement in a subsequent year to assure that the trust remains a grantor trust for the balance of the current year; and
9. methods of reinstating grantor trust status if the trust agreement does not authorize reinstatement of a trigger power include (i) decanting the trust into another trust that has a grantor trust trigger power, or (ii) merging the trust under state law merger provisions with another trust that has a grantor trust trigger power.

k. **Grantor Trust – Tax Reimbursement Clause**. Revenue Ruling 2004-64 held that the grantor's payment of income taxes attributable to a grantor trust is not treated as a gift to the trust beneficiaries. The trustee's power, in its discretion, to reimburse the grantor for income taxes attributable to the trust income does not necessarily cause inclusion in the grantor's estate under §2036(a), but may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law.

If state law says the grantor has the right to be reimbursed, there needs to be language in the trust instrument NEGATING the reimbursement right (or else §2036 would apply).

A number of states have amended their laws to provide that the mere existence of a discretionary power by the trustee to reimburse the grantor for income taxes attributable to the trust will not give creditors access to the trust. Even in those states, though, realize that the Bankruptcy Act (2005) states that if a person transfers assets to a trust and retains a beneficial interest in the trust and subsequently becomes bankrupt within 10 years, the bankruptcy creditors can reach the trust assets. Accordingly, a reimbursement clause could cause potential creditor issues if the grantor were to become bankrupt within 10 years.

Panelists prefer not to use a tax reimbursement clause but instead (i) rely upon the ability of the trustee to make distributions to the grantor's spouse (if the spouse is a beneficiary), which the spouse could use to pay income taxes, (ii) rely on the grantor's ability to turn off grantor trust status, or (iii) rely on the trustee's ability to loan money to the grantor to pay the income tax.

l. **Trusts as Beneficiaries of Retirement Plans – See Through Trusts**. If a trust is a beneficiary of a retirement plan, benefits can be paid over the lives of the beneficiaries only if the trust qualifies as a "see-through" trust: either a conduit trust (required to pay all retirement plan distributions to the beneficiary), or an accumulation trust meeting rigid requirements (in which event the payments can be made over the life expectancy of the oldest beneficiary). Broad powers of appointment are problematic with an accumulation trust, because possible appointees may include very elderly individuals, whose short life expectancies would become the limit on being able to "stretch out" distributions from the plan.

Structuring a trust to qualify as an accumulation trust is rather complex and requires restrictions that the grantor would likely not otherwise include. Legislative proposals have been made to require that all retirement plans be distributed over five years from the death of the participant (with limited exceptions). See Item 2.h above. If the mandatory five-year distribution rule is enacted, the complicated restrictions in accumulation trusts would be unnecessary. Consider providing flexibility in the trust provisions so that the necessary accumulation trust restrictions would not be applied if such legislation were to pass.

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

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

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

Powers of appointment can be structured to cause estate inclusion for a beneficiary in order (i) to achieve a basis adjustment at the beneficiary's death to the extent that estate inclusion would not generate estate taxes for the beneficiary, (ii) to permit the beneficiary to allocate GST exemption to the trust to the extent that the beneficiary has unused GST exemption, or (iii) to avoid payment of the GST tax upon a taxable termination, to the extent that the beneficiary has unused estate exemption.

These purposes may be achieved (as further discussed in Item 3.h.(4) above) by the use of:

1. a mandatory general power of appointment provision;
2. a formula general power of appointment provision (which may use formula provisions to describe the value of assets and order the types of assets [such as appreciated assets] over which the power is exercised);
3. an authorization for some third party to grant a general power of appointment to the beneficiary; or
4. the exercise of a limited power of appointment by the beneficiary in a manner that will trigger the "Delaware tax trap," which is generally accomplished by exercising the power to create a trust in which some other person has a presently exercisable general power of appointment (which extends the perpetuities period for the trust, thus triggering §2041(3)). A statute in Arizona permits triggering the Delaware tax trap by exercising a limited power of appointment to create another *limited* power of appointment in another individual in a certain manner (which avoids the problem of having to "stick" some person with the imposition of a general power of appointment (causing estate inclusion and potential creditor problems for that person).

n. **Sample Exercise to "Spring" Delaware Tax Trap to Obtain Basis Adjustment to the Extent of Beneficiary's Unused Estate Exemption Amounts.**

The following is a sample exercise of a limited power to trigger the Delaware tax trap by formula, (i) with respect to favored assets (generally to create the most tax advantage from basis adjustment under §1014), and (ii) up to the amount that would not increase the beneficiary's estate tax. In using such a clause, consider the anticipated expense that might be incurred in determining what assets are subject to the clause, based on the assets in the particular trust at issue.

Exercise of Powers of Appointment.

A. Identification of Power. Under the Last Will and Testament of my deceased [spouse] dated ___, ("my [spouse]'s Will") the ___ Trust (the "Trust") was created for my primary benefit. Pursuant to Section ___ of my [spouse's] Will, I have a Testamentary Power of Appointment to appoint all of the remaining property of the Trust (outright, in trust, or otherwise) to any one or more of my [spouse]'s descendants.

B. Exercise of Power. I hereby appoint the property described in Subsection C below to my children who survive me, in equal shares. However, if any child fails to survive me but leaves one or more descendants who survive me, I give the share that child would have received (if he or she had survived) per stirpes to his or her descendants who survive me. All of the preceding distributions are subject to the provisions of Article ___ (providing for lifetime Descendant's Trusts [*that grants the primary beneficiary thereof (or others) a presently exercisable general power of appointment*] for my children and other descendants).

C. Extent of Exercise. The foregoing exercise does not apply to the following assets held by the Trust: (i) cash or cash equivalent accounts (such as savings accounts, certificates of deposit, money market accounts or cash on hand in any brokerage or equivalent accounts); (ii) property that constitutes income in respect of a decedent as described in Code Section 1014(c); (iii) any interest in any Roth IRA accounts or Roth variants of other retirement plans, such as Roth 401(k)s, 403(b)s, 457(b)s, and the like; and (iv) any interest in any property that has a cost basis for federal income tax purposes that is greater than or equal to the fair market value of the property at the time of my death (the "Excluded Assets"). If, after eliminating the Excluded Assets, the inclusion of the value of the other assets in the Trust in my taxable estate for federal estate tax purposes would not increase the federal estate and state death taxes payable from all sources by reason of my death, this power of appointment shall apply to all remaining assets of the Trust other than the Excluded Assets (the "Included Assets"). However, in the event that the inclusion of the value of all of the Included Assets in the Trust in my taxable estate for federal or state estate or inheritance tax purposes would increase the taxes so payable, the assets of the Trust appointed by this Section shall be further limited as follows: The Trustee shall for each of the Included Assets evaluate the ratio of the fair market value at the time of my death to the cost basis immediately prior to my death first (the "Gain Ratio"). The Trustee shall thereafter rank the Included Assets in order of their respective Gain Ratio. The appointment shall apply first to the Included Asset with the largest Gain Ratio, and thereafter in declining order of Gain Ratio to each of the subsequent Included Assets; however, at such point that inclusion of the next in order of the Included Assets would otherwise cause an increase in my estate's federal or state estate tax liability as described above, my appointment pursuant to this Section ___ shall be limited to that fraction or percentage of that Included Asset that will not cause any federal or state estate tax liability, and all lower-ranked Included Assets shall be excluded from the exercise of this power of appointment.

D. Statement of Intent. It is my intention by the foregoing exercise of my power of appointment to trigger Code Section 2041(a)(3) by postponing the vesting of an estate or interest in the property which was subject to the power for a period ascertainable without regard to the date of the creation of my power, and to thereby obtain for the assets of the Trust the maximum possible increase in the cost basis of those assets as may be permitted under Code Section 1014 as a result of my death without causing any increase in the federal estate tax and state death taxes payable from all sources by reason of my death. This Will shall be administered and interpreted in a manner consistent with this intent. Any provision of this Will which conflicts with this intent shall be deemed ambiguous and shall be construed, amplified, reconciled, or ignored as needed to achieve this intent. (Clause by Mickey Davis, based on language loosely adapted from Morrow, *The Optimal Basis Increase and Income Tax Efficiency Trust* available at **http://tinyurl.com/qen5wl** at p. 86-87.)

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

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

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

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

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

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

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

"Retirement Age" for Trustee. Consider applying a "retirement age" for individual trustees, and allow beneficiaries to opt for continuation of the individual trustee if appropriate to provide a mechanism to address the trustee whose capacity is slipping.

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

Developed law exists in Delaware regarding directed trusteeships. State statutes are becoming more complete and thoughtful regarding directed trusteeships, such as in Missouri (see §808 of its Uniform Trust Code) and Alaska, among others. *See* RESTATEMENT (THIRD) OF TRUSTS §75; UNIF. TRUST CODE §808. The Uniform Law Commission has a project to develop a Uniform Directed Trust Act, expected to be completed in the summer of 2017. The discussion draft discussed in July 2016 provides that a directed trustee has no liability when acting at the direction of the adviser absent willful misconduct by the directed trustee, and has no duty to monitor the adviser. Be careful with the jurisdiction being selected if a directed trust relationship will exist.

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

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

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

The 2017 Heckerling materials contain detailed sample forms with trust protector powers.

r. **S Corporation Stock**.

(1) **Highlighting Importance of S Corporation Status**. If the trust is expected to own S corporation stock, the trust agreement should express an intent that the trustee take appropriate action to ensure that each trust created under the instrument satisfies the requirements to be an eligible shareholder of an S corporation under §1361 for as long as the trust holds any shares in any corporation that seeks to maintain status as an S corporation.

(2) **Requirements for Trusts as Qualified S Corporation Shareholders**. Three major types of trusts qualify as S corporation shareholders: (i) wholly-owned grantor trusts (§1361(c)(2)(a)(i)), (ii) trusts for which the trustee makes the electing small business trust (ESBT) election (§1361(e)), or (iii) a trust with a single beneficiary and that distributes all of the trust's fiduciary accounting income each year for which the beneficiary makes a Qualified Subchapter S Trust (QSST) election (§1361(d).

The ESBT is more flexible, because it can have more than one beneficiary and does not have to distribute all fiduciary accounting income currently. However, all of the S corporation income reflected on the trust's Schedule K-1 from the corporation is taxed to the trust at the highest individual income tax rate, with very few deductions (including that the income distribution deduction is not available). The trustee makes the ESBT election.

A QSST does not require a mandatory income distribution provision, but all of the trust's fiduciary accounting income must in fact be distributed during the year. Reg. §1.1361-1(j)(i). If the corporation makes no distributions, the trust would have no fiduciary accounting income with respect to the S corporation in that year; there is no requirement that all of the taxable income from the S corporation be distributed annually from the trust to the beneficiary. A provision in the trust agreement authorizing the trustee to accumulate trust income if the trust does not hold any shares of an S corporation does not, by itself, preclude the trust's qualification as a QSST. Rev. Rul. 92-20. The income beneficiary of a QSST is treated as a §678(a) deemed owner with respect to the S stock held by the trust as to which the beneficiary made a QSST election. Reg. §1.1361-1(j)(7)(i).

(3) **Make "Protective" ESBT Election for Grantor Trust**. The trustee should consider making an ESBT election for a grantor trust, in case, for whatever reason, the trust ends up not being a wholly owned grantor trust. Having the protective ESBT election can also be helpful in convincing cautious tax advisors of a future potential buyer of the company that the trust is qualified to hold S stock and that the S election is valid. The election is technically in effect, but the grantor trust rules will supersede the ESBT election as long as the trust is a wholly owned grantor trust. Reg. §1.641(c)-1(c). However, a reason not to make the protective ESBT election is that a grantor trust can use regular income taxation for the first two years after the grantor's death and obtain more favorable income tax treatment as a regular trust than as an ESBT. §1361(c)(2)(A)(ii). *See* Steve Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications* ¶ III.A.3.a.iii (2016) (available from the author).

(4) **Practical Problem with QSST Beneficiary Having Sufficient Cash Flow to Pay Income Tax**. An S corporation typically makes distributions of enough cash so that

the S Corporation shareholders can pay the federal income tax with respect to the S corporation income attributable to them. If the corporation distributes to a QSST its proportionate share of such "tax distributions" that it makes to all shareholders, the trust may not have enough remaining cash after paying administration expenses to distribute to the beneficiary so he or she can pay all of the income tax with respect to the S corporation income. Before making the QSST election, a beneficiary will typically want assurances that distributions will be made sufficient for the beneficiary to pay income taxes attributable to the S corporation income.

(5) **Practical Problem for QSST Beneficiary on Beneficiary's Death**. Assume that the QSST beneficiary dies in January 2018 before the S corporation has made distributions sufficient for the beneficiaries to pay income taxes with respect to the 2017 S corporation income. The corporation subsequently makes its "tax distributions" in March 2018. The trust remaindermen (following the beneficiary's death) will generally be entitled to receive that income, leaving the beneficiary with insufficient cash flow to pay income taxes with respect to the 2017 S corporation income. In addition, if the remaindermen are beneficiaries of the income beneficiary's estate plan, consider including language to keep the trust in place (with its QSST election), during the post-mortem trust administration, so that income is not trapped in the trust during that time and taxed at high rates.

Sample Clause:

> The following paragraphs apply upon the death of the beneficiary of a trust with respect to which a QSST election is in effect immediately before the beneficiary's death, if and to the extent not overridden by a power to Appoint:
>
> (1) If the individuals to whom the S corporation stock is allocated do not share in the residue of the deceased beneficiary's estate (in this or Agreement, Article ___ determines the sharing of the residue of my estate, because my will bequeaths my estate to the Revocable Trust and Article ___ bequeaths the residuary trust assets), then any distributions the S corporation makes to pay its shareholders' taxes with respect to their distributive shares of taxable income before the date of death shall be treated as income earned before the beneficiary's death and paid to the beneficiary's revocable trust entitled to the residue of the beneficiary's estate, if any, otherwise to the beneficiary's estate.
>
> (2) If and to the extent that paragraph (1)__ does not apply, during trust administration, after the beneficiary's death and before separate trusts can be funded, the trust will not terminate but rather will continue as a single trust with separate shares pursuant to U.S. Treas, Reg. section 1.1361-1(j)(9)(ii), Example (1), Section __ shall not apply, and the trusts for the beneficiaries will be amended under paragraphs (1)__, (2)__, and (3) of subsection (A)_. (Clause by Steve Gorin.)

s. **Capital Gains in DNI**. Capital gains ordinarily are excluded from DNI (so that capital gains are ordinarily taxed at the estate or trust level). Reg. §1.643(a)-3(a). However, the regulations provide that capital gains will be included in DNI if they are, pursuant to the terms of the governing instrument and applicable law or pursuant to the trustee's discretion (1) allocated to income, (2) allocated to corpus and consistently treated as being a part of distributions, or (3) allocated to corpus and actually distributed or taken into consideration in determining what is distributed. Reg. §1.643(a)-3(b).

For a discussion of planning opportunities for each of these three possibilities, see Item 18.b of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor** and Item 9.n of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**

Sample Clauses.

An example clause giving the trustee discretion to utilize the flexibilities afforded by the regulation to cause capital gains to be in DNI is as follows:

> The Trustee may allocate realized short term capital gains and/or realized long term capital gains to either trust income or trust principal, and such gains shall be includable in distributable net income as defined in I.R.C. § 643 and the regulations thereunder (1) to the extent that such gains are allocated to income and distributed to the trust beneficiary, or (2) if such gains are allocated to principal, to the extent they are consistently treated as part of a distribution to the trust beneficiary, actually distributed to the trust beneficiary, or used by the Trustee in determining the amount distributable to the trust beneficiary.

Gregory Gadarian, *Including Capital Gains in DNI,* ACTEC 2014 Fall Meeting of Fiduciary Income Tax Committee.

Another very simple sample clause, utilizing just the first of the alternatives (of allocating capital gains to income) is provided by Susan Bart:

> **Allocation of Capital Gains to Income.** The Trustee may allocate to income all or part of the gains from the sale or exchange of trust assets as the Trustee considers appropriate.

9. Structuring Trusts and Other Planning to Protect Beneficiaries from Divorce Claims

a. **Changed Paradigm from Traditional Planning**. Estate planning attorneys typically spend as much time discussing protecting beneficiaries from creditors generally as planning for protection from a spouse in a divorce action. That is ironic because relatively few beneficiaries have experienced creditor attacks on their trusts, but divorce actions are common. Planners should spend more time discussing how to protect beneficiaries from divorce claims. Traditional trust drafting often does not do that. Planners often focus on providing control, flexibility and tax savings for the beneficiary. Those provisions hurt with respect to divorce claims. The more control/interest the beneficiary has in the trust, the more likely it will be treated as marital property or will be considered in determining how property that does constitute marital property is divided or in setting alimony.

Strings that may be allowed without causing estate inclusion for a beneficiary can lead to problems in protecting the trust assets if the beneficiary divorces. Good family lawyers pride themselves in being creative when arguing fairness in a court of equity, with many tools at their disposal to convince the judge to do what he or she thinks is fair.

b. **Prenuptial Agreements**.

(1) **Broader Than Just Divorce**. Prenuptial agreements protect not just against divorce but also provide postmortem planning. Structuring a good prenuptial agreement takes a team of both a trust lawyer and family lawyer to structure an effective prenuptial agreement and to determine if other trusts should be prepared separately from the prenuptial agreement.

(2) **Fund Trusts if Required in Agreement.** If the prenuptial agreement calls for funding the trust and if the trust is not actually funded, the agreement may not be recognized. In one situation, a spouse argued that the other spouse abandoned the agreement and its protection by not funding a trust as required in the agreement. No cases say that – those types of cases settle – but failing to fund the trust leaves an opening for attacks on the agreement.

(3) **Trend Toward Disrespecting Agreements in Long Marriages.** For short-term marriages, the trend is to uphold prenuptial agreements if proper disclosure has been made. For long marriages (30-40 years), however, the trend throughout the country is to find some way to divide all of the spouses' assets evenly between the spouses. (Some planners even question whether prenuptial agreements should have a sunset provision after the marriage has existed for a specified number of years.)

(4) **Who Should Draft Prenuptial Agreements?** Family lawyers maintain that estate and trust lawyers are excellent when drafting and structuring for transfers at death, but for structuring what happens on dissolution of the marriage, the agreement should be drafted by a family lawyer.

Many family lawyers will not draft prenuptial agreements because they are ticking time bombs. Unless they are very carefully structured, in 10-20 years they can come back and bite the planner.

The best practice is to (i) assemble a cooperative team to address post-mortem and marriage dissolution issues, (ii) disclose, disclose, disclose, and (iii) overvalue. (Planners never see agreements set aside because assets are overvalued, but they can be endangered if disclosed assets are undervalued.)

(5) **Disclosing Anticipated Inheritance**. The conservative approach is to disclose and give an estimated range of anticipated inheritances. In some states (such as Florida), divorce courts cannot consider anticipated inheritances, but in other states mere expectancies can be considered in divorce proceedings. In those jurisdictions, anticipated inheritances absolutely should be disclosed. Even if values are unknown, disclose that the person expects to be named as a beneficiary in parents' wills.

(6) **Discussing the Concept of Prenuptial Agreements with Prospective Spouses.** Bruce Stone (Miami, Florida) describes how he discusses prenuptial agreements with clients. He explains that he has an agreement with his wife that was entered into 39 years ago. He didn't sign anything, but the Florida legislature provided it. Furthermore, if he moves to another state, he will have another agreement provided by that state. He explains that the prospective spouses have the opportunity to enter into an agreement themselves, and asks whether they would rather have the legislature set the agreement or be able to set the terms of their own agreement.

(7) **Resource**. The book "Prenups for Lovers: A Romantic Guide to Prenuptial Agreements" by Arlene Dubin presents prenuptial agreements in way that is nonadversarial. Some planners give this book to prospective spouses if one or both of the parties may be seeking to have a prenuptial agreement.

c. **Trusts – Trend Toward Longer and More Discretionary Trusts.** Several decades ago, many trust instruments tended to terminate at ages 25, 30 and 35 for beneficiaries. Later, a trend developed to leave assets in trust allowing the children to withdraw after certain ages. An emerging trend is to suggest distributions that might be made at certain ages, but provide that distributions are totally discretionary with the trustee. Long-term sprinkling dynasty trusts, perhaps with totally discretionary distributions, are becoming more normal. This trend reflects, in part, an increasing concern with "predator protection."

d. **Traditional Spendthrift Principles.** Under traditional trust law principles, trust assets will be more protected from claims of creditors of beneficiaries if the trust is a pure discretionary trust (rather than having ascertainable standards for distributions) and if the beneficiary is not the trustee (at least with a discretionary trust). In addition, spendthrift provisions provide protection against a beneficiary's creditors, but many states have adopted "exception creditors" including claims for child support and alimony that may reach trust assets despite the spendthrift provision.

   UTC – Spendthrift Clause. Under the Uniform Trust Code, a spendthrift clause protects against a beneficiary's general creditors (§502(c)), but does not protect against exception creditors (including a spouse, child, a former spouse who has a judgment against the beneficiary for support or maintenance and certain others) (§503(b)). Exception creditors may obtain a court order attaching present or future distributions to or for the benefit of the beneficiary, which the court may limit as appropriate under the circumstances. §503(c). For support trusts (with a standard for distributions that is *not discretionary*), a creditor apparently can seek to have a court compel the trustee to make a distribution under the distribution standard. *Cf.* §504(b) (trustee of *discretionary* trusts generally cannot be compelled to make distributions, whether or not a spendthrift clause applies).

   UTC – Discretionary Trusts. The Uniform Trust Code also provides protection to discretionary trusts even in the absence of a spendthrift clause. §504(b). Furthermore, discretionary trusts protect against even exception creditors unless an abuse of discretion has occurred. §504(c). Discretionary trusts are trusts that give the trustee discretion in whether to make distributions, whether or not a distribution standard exists (such as for health, education, support, or maintenance) and whether or not the language of discretion is combined with language of direction (such as "shall, in the trustee's absolute discretion, distribute such amounts as are necessary for …"). *See* §506(a). For a trust with a standard of distribution that is also subject to the trustee's discretion, the trustee generally cannot be compelled to make distributions whether or not a spendthrift clause is present (even if the trustee has abused the discretion), but the trustee can be compelled to make distributions under the standard to satisfy a judgment for support or maintenance of the beneficiary's child, spouse, or former spouse (even if the trust has a spendthrift clause). §504(c). In any event, if a trustee voluntarily makes a distribution to a beneficiary, the assets can be reached by the beneficiary's creditors. §502 Comment.

   Non UTC States. In non-UTC states, a "pure" discretionary trust permits distributions under a trustee's "sole," "uncontrolled," or otherwise unlimited exercise of discretion, and does not include a governing standard for trust distributions. H.S. SHAPO, G.G. BOGERT, & G.T. BOGERT, TRUSTS AND TRUSTEES §228.

Control as a Factor. Beneficiaries with substantial control over the trust who do not respect the trust formalities may subject the trust assets to potential creditor claims. *But see* UNIF. TRUST CODE §504(e) (creditors of beneficiary-trustee subject to ascertainable standard cannot reach trust assets). For example, assume that a beneficiary who is the trustee of a trust has an auto accident causing monumental damages and loses the tort trial resulting in a large judgment against him. The individual will likely be back in front of the same judge that tried the underlying tort case as the plaintiff tries to collect the judgment. The lawyer will ask if the individual was the sole trustee of the trust. Were proper trust procedures followed in administering the trust? Were trust accountings prepared? Were tax returns filed timely and correctly? Did the individual treat the trust as his personal checkbook? If the beneficiary/trustee has been sloppy in administering the trust, the trust may be penetrated. The trust does not provide absolute protection against creditors of the beneficiary. The fewer strings and less control that the beneficiary has over the trust, the more likely that the trust will stand up against creditor attacks on the trust.

Assets that would seem to be protected from beneficiaries' creditors under general spendthrift principles, however, may be more subject to claims in a divorce context.

e. **Increasing Attacks on Trusts in Divorce Proceedings**. The scenario described above with a trust beneficiary who has substantial control over the trust and who does not respect the trust also applies in the divorce context. The divorce judge in a court of equity is looking for equity and fairness and may be even more inclined than a judge in the traditional tort context to reach (or at least consider) the trust assets that are available to one of the spouses. Family lawyers are taking CLE courses about how to find assets in trusts and how to attack trusts. A case in Hong Kong awarded $1 billion of assets from a trust in a divorce matter. Bruce Stone warns: "Take off your trust and estate hat when you venture into this divorce area. It is a different world. They think differently. The rules are different." Scott Rubin (family lawyer in Miami, Florida) adds that "in the family lawyer's world, a living trust is always revocable."

The issue can arise either in situations in which one of the spouses was the settlor of a trust or was the beneficiary of a trust established by a third party. In the settlor context, if one spouses creates a trust naming that spouse as a discretionary beneficiary in a DAPT state, will the trust assets be considered as marital assets? Or if one spouse makes a transfer to an inter vivos QTIP trust or to a SLAT for the benefit of the other spouse, will those assets be treated as a gift to the other spouse, or will they be treated as marital assets?

The *Pfannenstiehl* divorce litigation in Massachusetts is illustrative of the issues that can arise regarding trust interests in the third-party context. The trial court considered the husband's interest in a discretionary spendthrift trust created by his father as a marital asset, and ordered the husband to pay about $1.4 million from the trust to his wife. The trust provided for distributions to husband and the father's other descendants for their "comfortable support, health, maintenance, welfare and education" in the trustee's "sole discretion" as they "may deem advisable from time to time." The Massachusetts Supreme Judicial Court reversed the trial court's prior finding that the trust interest was part of the marital estate. The court did leave open two important issues for the trial court's consideration on remand: (i) the trust could be considered as an expectancy in determining how to divide the assets that are subject to division, and (ii) the court could revisit whether alimony is now appropriate in light of "any future stream of [trust] income from distributions." *Pfannenstiehl v. Pfannenstiehl,* SJC-12031, (Mass. Sup. Jud. Ct. Aug. 4, 2016). For a more detailed summary of *Pfannenstiehl*, see Item 7.i of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

f. **Fundamental Issues Regarding Property Division in Divorce.** Divorce basics are that (i) marital property (or community property) is identified and divided equitably, and (ii) support and alimony are determined separately based on various factors. Whether trust assets can be reached in a divorce context arises with respect to these two separate issues: (i) equitable distribution of the marital assets (and whether some or all of the trust assets are treated as marital assets that can either be taken out of the trust and awarded to the other spouse or can be taken into account in dividing all of the marital assets), and (ii) whether the trust assets can be considered in setting maintenance or alimony (and secondarily if the trust assets can be reached if such payments are not made). Under the laws of many states, all income of a spouse, whether marital assets or not, is included in determining the ability to pay alimony.

Assets acquired during the marriage are typically treated as marital property subject to division, but gifts and inheritances are typically not treated as marital assets (or are allocated to the spouse who received the gift/inheritance). Major factors influencing whether trust assets are marital property are the use of the trust property during the marriage and restrictions (or lack of restrictions) in the trust agreement on the beneficiary's access to the trust assets.

g. **Impact of Trust Choice of Law Provision and Trust Situs**. Where the trust was settled, the choice of law provision, the trust situs, and the place of the divorce may all have an impact on the ability to reach trust assets in the divorce proceeding. For example, some states (such as Nevada, Alaska, and South Dakota) do not provide for exception creditors to a spendthrift trust.

The choice of law provision in the trust agreement will not automatically control, however. The governing law provision in the trust instrument generally controls "unless the designation of that jurisdiction's law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue." UNIF. TRUST CODE §107(1); RESTATEMENT (SECOND) OF CONFLICT OF LAWS §270 (addressing trust validity). Issues arising in the marital and family context are often considered as raising uniquely powerful public policy issues.

The public policy issues tend to be much stronger in divorce cases than in traditional creditor cases, and in many situations, the law of the place of the divorce will control. For example, in *Dahl v. Dahl*, 345 P.3d 566 (Utah 2015), spouses were divorced in Utah, and before the divorce, the husband had created a self-settled trust under Nevada law (which provided creditor protection to the settlor-beneficiary). The court did not consider whether the trust assets were part of the marital estate because the wife's attempt to join the trust as a party shortly before the trial was rejected as being untimely. The wife brought a separate action, also in Utah, seeking a declaration of her rights in the trust assets and requesting an accounting. The Utah Supreme Court considered both the divorce and declaratory judgment actions in a consolidated case. It reasoned that Utah's choice of law rules would enforce a choice of law provision in a trust unless it would "undermine a strong public policy" of the state. The court concluded that it could not apply Nevada law without violating Utah public policy. *Id.* at 579.

h. **Drafting Considerations.**

(1) **Distribution Rights Will be Limited Unless Beneficiary's Spouse Waives Rights**. Bruce Stone includes a provision in most trusts that he writes providing that only an independent trustee can make distributions to a married beneficiary, and a married beneficiary will only be entitled to distributions "for that beneficiary's immediate and direct needs for his or her own personal health and basic support needs for food, clothing, and shelter" after considering the beneficiary's other available income and resources unless the beneficiary's spouse irrevocably and permanently waives all rights of any nature which the spouse might have in a beneficial interest in the trust, marital property rights in the trust, or the right to attach trust assets to satisfy the beneficiary's obligations arising out of the dissolution of the marriage. He explains the provision to clients, and only several have asked him to remove the clause.

Several times he has added that the beneficiary's spouse must sign such a waiver annually (but he notes that most clients will not stomach that strict of a provision).

Sample Clause (by Bruce Stone):

Restrictions Applicable to a Married Beneficiary

1. The following rules apply with respect to all distributions to or for the benefit of each beneficiary of a separate trust under clause XX (whether the primary beneficiary or a descendant of the primary beneficiary) who is married. [*Note: XX refers to the number of the article or clause in the will or trust instrument governing distributions.*]

1.1 No Trustee other than an Independent Trustee may make any distribution or decisions with respect to distributions to or for the benefit of that beneficiary.

1.2 The Independent Trustee is prohibited from making any outright distributions to that beneficiary for any purpose other than amounts required for that beneficiary's immediate and direct needs for his or her personal health and basic support needs for food, clothing, and shelter, after taking into account all other available income and resources known by the Independent Trustee to be reasonably available to that beneficiary for those purposes. It is my intention by this provision to prohibit distributions that would allow a beneficiary to accumulate funds to preserve or increase his or her personal net worth or enhance in his or her marital lifestyle, whether directly or indirectly by allowing the beneficiary to rely on trust distributions instead and thus preserve his or her own assets and resources.

1.3 The provisions of clauses 1.1 and 1.2 will apply at all times while that person is married, whether he or she was married upon the creation of the trust or becomes married after creation of the trust, except as follows.

1.3(a) Distributions to or for the benefit of a beneficiary who is married will be governed as otherwise provided in clause XX and without regard to the restrictions set forth in clauses 1.1 and 1.2 if the spouse of that beneficiary has executed a written instrument satisfactory to the Independent Trustee in content and form which irrevocably and permanently waives all rights of any nature which the spouse of that beneficiary might have or assert claiming each of the following:

1.3(a)(1) a direct or indirect beneficial interest in the trust, including an interest awarded by judgment, court order, or other involuntary assignment, other than beneficial interests specifically conferred upon the spouse by me under the terms of this [Will] [trust instrument] (such as by naming the spouse is a beneficiary by specific reference to his or her name, or by specific reference as the spouse of a descendant of mine, or by including the spouse as a permissible appointee under a power of appointment),

1.3(a)(2) marital property rights, community property rights, or other direct or indirect ownership interests in the beneficiary's beneficial interest in the trust, and

1.3(a)(3) the right to bring proceedings against the trustee, the trust estate, or any person or financial institution holding trust assets seeking to garnish, attach, or otherwise satisfy obligations of the beneficiary to his or her former spouse arising out of the dissolution of the marriage.

1.3(b) The waiver must expressly state that it runs in favor of the Trustee, the beneficiary to whom that spouse is married, and all other persons having a beneficial interest in the trust estate, and it must be delivered to the Independent Trustee. The waiver may be executed before or after the marriage to that beneficiary.

1.3(c) If a beneficiary's spouse executes a waiver in accordance with the provisions of clause 1.3, and either the beneficiary or that beneficiary's spouse thereafter changes his or her residence to another jurisdiction while they are still married to each other, the restrictions set forth in clauses 1.1 and 1.2 will once again govern distributions to that beneficiary unless the spouse of that beneficiary executes another waiver in accordance with the provisions of clause 1.3 which is satisfactory to the Independent Trustee in content and form under the laws of the jurisdiction in which the new residence is located.

1.3(d) The Independent Trustee will not be liable to anyone for decisions to make distributions based on a waiver that is later determined to be invalid, or for refusing to make distributions if the Independent Trustee believes the waiver to be invalid, if the Independent Trustee obtains legal advice about the effectiveness of the waiver and otherwise acts in good faith.

1.4 The provisions of clauses 1.1 and 1.2 will not apply to a beneficiary during any time when he or she is not married (whether never married, or whether married previously if the marriage has terminated because of the death of his or her spouse or by dissolution in legal proceedings during lifetime), except as follows. The provisions of clauses 1.1 and 1.2 will continue to apply at all times even after dissolution of a beneficiary's marriage if it was finally determined that the beneficiary's former spouse has rights or interests described in clauses 1.3(a)(1) or 1.3(a)(2), or while proceedings described in clause 1.3(a)(3) are pending, until the beneficiary's former spouse (or the legal representative or successor in interest of the beneficiary's former spouse) is legally barred from efforts to seek to enforce those rights or obligations, or to bring those proceedings, whether because of reversal of the award, death, passage of time, satisfaction, or other reason.

1.5 It is my specific intention not to allow distributions for purposes beyond the immediate and direct personal needs for support and help of a beneficiary who is married as permitted in clause 1.2 which might be used to support or enhance his or her marital lifestyle, and which might lead to claims of reliance by the beneficiary's spouse in the event of divorce, and the assertion of claims for beneficial rights or interests with respect to income or principal of the trust estate, whether directly in the nature of a beneficial interest in the trust, or indirectly through the assertion of marital property rights or other interests in the beneficial interest of that beneficiary, unless the beneficiary's spouse has irrevocably and permanently waived the right to assert all claims and rights as provided in this clause 1. Unless I have made provisions for other persons by explicit terms in this [Will] [trust instrument], I intend for the assets which I have acquired during

> my lifetime to be used only for the benefit of my spouse and my descendants as provided in this [Will] [trust instrument]. I disavow any intention to make provisions for anyone else, including the spouses of my children and descendants, as it is their responsibility, not mine, to provide for their own spouses from assets and resources they acquire on their own efforts. I direct the Trustees to enforce these provisions rigorously, and to take a narrow and conservative view of the distributions which are permitted to be made to a married beneficiary in the absence of an irrevocable and permanent waiver that by that beneficiary's spouse.

The remaining drafting considerations summarized below are from Jocelyn Borowsky & Rebecca Wallenfelsz, *Third Party Spendthrift Trusts in the Context of Divorce*, 42ND ANN. NOTRE DAME TAX & EST. PL. INST. (Oct. 28, 2016).

(2) **Discretionary Distributions By Third-Party Trustee Without Ascertainable Standards.** A beneficiary can argue lack of any control over the trust and distributions if distributions may only be made in the full and absolute discretion of a third-party trustee. As discussed in Item 9.d above, under the Uniform Trust Code, if the trust has ascertainable standards, whether or not subject to the trustee's discretion, the trustee can be compelled to make distributions to satisfy a judgment for support of the beneficiary's spouse or former spouse. UNIF. TRUST CODE §504(c). The presence of an ascertainable standard may even cause the trust to be treated as marital property in some states. *E.g., Comins v. Comins*, 33 Mass. App. Ct. 28, 30-31 (1992), *distinguished in Pfannenstiehl v. Pfannenstiehl*, 55 N.E.3d 933 (Mass. 2016).

(3) **Independent Trustee.** Divorce courts may give more deference to discretionary distribution decisions made by a disinterested, independent trustee. Any third-party trustee would be safer than the beneficiary as trustee. Indeed, if a beneficiary-trustee resigns as trustee during the divorce proceedings, the beneficiary could be held in contempt. *See In re Kloiber*, 98 A.3d 924 (Del. Ch. 2014).

(4) **Expand Spendthrift Provisions**. Draft the spendthrift clause to refer specifically to a spouse and former spouse.

(5) **Kick-Out Provision**. The trust might include a provision eliminating a beneficiary's interest in the trust while subject to divorce obligations or bankruptcy proceedings.

An extreme form of such a clause is as follows:

> Notwithstanding the preceding provisions of this Agreement, if the Trustee determines that circumstances adverse to a Beneficiary exist that would make it clearly contrary to the best interests of such individual to receive a distribution of income or principal, the Trustee shall refrain from making any discretionary distribution to such individual until the Trustee determines that such circumstances no longer exist. Circumstances adverse to a Beneficiary that would justify exercising such discretion include, without limitation: being a defendant in serious litigation or being involved in bankruptcy or similar proceedings; severe financial or matrimonial difficulties; alcohol or substance abuse problem; falling under the influence of a person or group (such as a religious cult) that might tend to make the Beneficiary spend or dispose of money unwisely; having otherwise demonstrated profligate spending habits; gambling problem; incarceration for felony; being physically, mentally, or emotionally unable to properly administer the assets to be distributed; living under a form of government or other condition making it highly likely that the assets to be distributed will be subject to confiscation or expropriation; potential or pending creditor claims; or any other similar substantial cause. Jocelyn Borowsky & Rebecca Wallenfelsz, *Third Party Spendthrift Trusts in the Context of Divorce*, 42ND ANN. NOTRE DAME TAX & EST. PL. INST. at 13-14 (Oct. 28, 2016).

(6) **Powers of Appointment**. Powers of appointment add significant flexibility, such as the ability to appoint the assets to someone other than the beneficiary going through a divorce or to remove the beneficiary's interest in the trust.

i. **Trust Administration Considerations**. The following trust administration considerations, suggested in Jocelyn Borowsky & Rebecca Wallenfelsz, *Third Party Spendthrift Trusts in the Context of Divorce*, 42ND ANN. NOTRE DAME TAX & EST. PL. INST. (Oct. 28, 2016),may also assist in insulating trust assets in a divorce proceedings:

1. No patterns of distribution;
2. Formalize the discretionary decision-making process regarding distribution decisions;
3. Modifying problematic aspects of the trust agreement prior to the divorce (preferably well prior to the divorce);
4. Delay distributions if a beneficiary's divorce is anticipated or following entry of a judgment in a divorce proceeding;
5. Seek court intervention by the trustee to protect the trust (for example, petitioning for instructions, a declaratory judgment, or a protective order);
6. Avoid drastic changes in administration during divorce proceedings;
7. Consider migrating the trust to a state with stronger creditor protection; and
8. When a beneficiary is involved in a contested divorce proceeding, engage counsel and consider what the trust can reasonably do to protect itself and to consider the extent to which the trust could or should participate in the settlement discussions to minimize dissipation of the trust.

10. Privacy and Personal Security

The information in this item is based upon information from a panel discussion by John F. Bergner (Dallas, Texas), R. Kris Coleman (with a security firm in McLean, Virginia) and Mark Lanterman (with a computer forensics firm in Minnetonka, Minnesota). The article by John Berger is a tremendous resource, and much of this Item is organized the same as that article. The article also contains a variety of excellent forms including an anonymous donation agreement, various types of non-disclosure agreements and clauses, and arbitration clauses.

a. **Important Often Overlooked Issue for Clients.** Raising the consciousness of clients and assisting them with privacy and personal security concerns is an important service that planners can provide that is independent of the uncertainty surrounding the possibility of estate tax repeal. Issues include structuring plans in a confidential manner, taking steps to prevent the disclosure of confidential information, avoiding public litigation, maximizing privacy at death, and protecting against physical and cyber-attacks.

Having absolute privacy and perfect security obviously is not possible. Proactive planning is essential to both, however; "after-the-fact" is too late once confidential information has been disclosed or security is endangered. The planner can assist the client in balancing, in the client's particular situation, the need and desire for privacy and security with the inconvenience and cost impact that various alternatives will require.

b. **Utilizing Revocable Trusts**. Structuring the estate plan in a revocable trust, with a pour-over will, can keep details of the plan private at the client's death. Using fully funded revocable trusts can avoid disclosure of assets in probate proceedings. Revocable trusts can also facilitate anonymous ownership of assets, to the extent that the client chooses a non-identifying name for the revocable trust and a third-party trustee.

c. **Limiting Disclosure of Information to Beneficiaries**.

(1) **Silent Trusts**. A trustee's general duty under common law (and the Uniform Trust Code) to keep beneficiaries informed may be modified under the laws of various states that have passed statutes authorizing "silent trusts." For a discussion of the advantages and disadvantages of using silent trusts, see Items 44-52 of the ACTEC 2014 Fall Meeting Musings Summary (Dec 2014) found **here** and available at **www.Bessemer.com/Advisor**.

(2) **Basis Consistency Rules**. Basis consistency reports are due to beneficiaries 30 days after the due date of the estate tax return. If an executor has not determined what assets will be distributed by that time, all assets from the gross estate that could possibly be used to satisfy the bequest must be disclosed to the beneficiary on a Schedule A to Form 8971. See Item 4.i.(4) above. This may cause real family problems. For example, if an estranged child is a beneficiary under the will, the executor (and the rest of the family) may be very reluctant to disclose all of the estate assets to that child. Planning solutions include (i) funding bequests with non-probate assets, (ii) requiring that bequests be satisfied with cash, (iii) using multiple funded revocable trusts (so that, at most, only the assets in a particular funded revocable trust would have to be disclosed to beneficiaries of that particular trust); (iv) liquidating estate assets to satisfy bequests before the due date of the reports, (v) borrowing cash to satisfy bequests, or (vi) setting aside assets to satisfy bequests.

d. **Titling Real Estate and Other Assets**. If a client wants to keep his or her ownership of particular assets anonymous, assets could be acquired in a business entity or revocable trust with a name that is not associated with the client. For example, real estate may be acquired in an entity having the address of the property or some other nondescript term as the name of the entity. (Jennifer Aniston's Manhattan home, for example, is owned by the "Norman's Nest Trust," named after her dog). In selecting the manager or trustee, use a third person because otherwise the client's name may appear in closing documents, financial paperwork, state filings, and online deed records. A trust may preserve anonymity better than an LLC because LLCs are often required to file various reports with state authorities (sometimes including the names and addresses of the members, managers, officers and directors). Trusts may also be preferable in being able to maintain homestead exemptions; some states allow homes owned by certain trusts to qualify for the homestead exemption. Before transferring real property to a trust or LLC, confirm with local counsel whether the transfer will be subject to a real property transfer tax.

Properly structured “gun trusts” can maintain privacy over the ownership of gun collections, while ensuring compliance with state and federal laws regarding the disposition of such firearms upon death.

A client may wish to keep ownership anonymous for various other types of assets as well, including automobiles, watercraft, aircraft, wine, gold, precious stones, coins, antiques, artwork, legal marijuana businesses, etc. Ownership through revocable trusts or LLCs could preserve the owner’s anonymity.

e. **Charitable Planning**.

(1) **Motivations.** Motivations for anonymous giving include a desire to minimize solicitations, to keep anonymous for philosophical reasons, to avoid the public spotlight, and to avoid personal security risks.
(2) **Methods of Anonymous Giving.** Methods for giving anonymously include –

1. giving directly to a public charity (while the Form 990 for public charities must list substantial contributors, the IRS is required to redact the names and addresses of substantial contributors before it is publicly available),
2. giving through an agent under a written agency agreement or limited power of attorney (the charity’s written acknowledgment of the gift may be used by the client to claim a charitable income tax deduction; if the gift must be reported on a Form 990 as a gift from a substantial contributor, the Instructions permit the donor to be identified as “anonymous” rather than disclosing the client’s or agent’s name and address),
3. giving through a revocable trust or LLC (with a name that is not easily recognizable and that has a separate taxpayer identification number),
4. giving to a designated fund at a community foundation (only the foundation’s staff, but not the public, would be aware of the donor),
5. giving to a donor advised fund (gifts through a donor advised fund would allow anonymity to both the public and the ultimate charity), or
6. giving through a private foundation, by having the foundation make gifts to a designated fund or donor advised fund (grants from a private foundation directly to a public charity must be reported on the foundation’s Form 990).

f. **Political Contributions**. Political contributions made directly to a candidate or campaign committee are accessible on the Federal Election Commission’s website. Gifts to a §501(c)(4) organization must be disclosed on Schedule B of Form 990, but the names and addresses of contributors can be redacted before the Form 990 is made public. Contributions to a §501(c)(4) do not qualify for a charitable income tax deduction (but may be deductible as a trade or business expense if they are ordinary and necessary in conducting the client’s business).

g. **Financial Privacy Planning**.

(1) **Selection of Advisors.** Personal efforts in safeguarding financial information is the most effective means of securing financial privacy. Careful selection of banks,

financial advisors and professionals will help ensure that the advisors maintain security measures to preserve client confidentiality.

(2) **Public Companies and Insiders**. Disclosure of detailed information is required for public companies and insiders under the federal securities laws. The required disclosures include the insider's compensation, including grants of stock options and stock appreciation rights, long-term incentive plan awards, pension plans, and employment contracts and related arrangements. Insiders of public companies include executive officers, directors, and 10% beneficial owners.

(3) **Lottery Winners.** Disclosure requirements for lottery winners are primarily set by state lottery commissions. A few states permit winners to protect identities. (For example, winners in Texas have the option to be private.) Most states, however, require that winners' names be made public (and sometimes that the winners participate in a press conference). Protecting the client's identity may be possible by claiming winnings through a trust or LLC or, in some states, by an attorney acting as trustee or agent for the client. For example, in 2010, a $260.6 million Powerball jackpot was claimed by an attorney, acting as trustee, on behalf of an anonymous client.

(4) **Banking Disclosures**. Persons opening bank accounts must disclose various types of information under the Bank Secrecy Act, and under the Know Your Customer rules of the USA PATRIOT Act. The Financial Crimes Enforcement Network ("FinCEN") adopted rules expanding disclosure requirements to include ultimate beneficial owners of legal entity customers. The Financial Action Task Force has made recommendations, including that information regarding the settlor, trustee and beneficiaries of express trusts should be publicly available (but those recommendations have yet to be adopted in the United States – and hopefully they never will be).

h. **Medical Privacy.** A client may request doctors, caretakers, staff, and family members to sign a non-disclosure agreement regarding the client's medical information. The Health Insurance Portability and Accountability Act ("HIPAA") prohibits "covered entities" from disclosing medical records. Clients often sign waivers allowing the release of medical information to family members; clients particularly concerned about the release of medical information could require those family members to sign non-disclosure agreements.

Many clients do not realize that insurance companies often have access to the client's medical records as members of MIB Group, Inc. for underwriting purposes.

i. **Non-Disclosure Agreements**. Non-disclosure agreements are contracts containing a promise not to disclose information that may specify damages if the agreement is breached. They can be extremely flexible, customized to the particular situation.

(1) **Common Uses.** Common uses of non-disclosure agreements include agreements for employees, professional advisors, and for business practices and technology.

In addition they may be used in pre- and post-marital agreements. Donald and Ivana Trump's agreement included the following provision, which was upheld by a New York appellate court:

> Without obtaining [husband's] written consent in advance, [wife] shall not directly or indirectly publish, or cause to be published, any diary, memoir, letter, story, photograph, interview, article, essay, account, or description or depiction of any kind whatsoever, whether fictionalized or not, concerning her marriage to [husband] or any other aspect of [husband's] personal, business or financial affairs, or assist or provide information to others in connection with the publication or dissemination of any such material or excerpts thereof.

The marital agreement provided that a violation of the clause constituted a material breach of the contract which would terminate Donald's obligation to make certain payments to Ivana, and that he could seek a temporary or permanent injunction to prohibit her from disclosing any confidential information.

"Cupid contracts" may be used to require romantic partners from disclosing sensitive information with the threat of monetary penalties and injunctive relief.

Some celebrities have used nondisclosure agreements in connection with parties and weddings. (The materials include a copy of an agreement that Justin Bieber reportedly required his guests to sign before attending a party, imposing a $3 million penalty for disclosing confidential information.)

(2) **Common Provisions**. The agreement must carefully describe what constitutes "confidential information" in the particular situation, the term of the agreement, and may include exceptions to disclosure (for example, that agents may disclose information as required to perform their jobs), a non-disparagement clause, a digital privacy clause, and provisions for alternate dispute resolution and sealing court records. The agreement typically contains remedies for a breach, which can include injunctive relief to prevent further disclosure and liquidated damages.

j. **Litigation Alternatives for Privacy**. To avoid ugly public legal proceedings, parties may use alternative dispute resolution procedures including mediation and arbitration. Such privacy can also be important for tax reasons. Publicity over a publicly litigated family dispute involving the Redstone (Viacom) family led to huge gift tax assessments and extended subsequent litigation with the IRS (discussed in Item 18.h below).

k. **Dealing With Public Courts**.

(1) **Private Trials.** Most states permit "private trials," in which parties may request the acting judge to refer the case to a private judge in a private proceeding, thereby maintaining privacy even if unable to avoid court involvement.

(2) **Sealing Civil Court Records**. Obtaining sealing of civil court records depends upon local rules, and typically hinges on a finding of a substantial interest in favor of secrecy that outweighs the public's presumptive right to access. Wills are rarely sealed. In New York, divorce proceedings are automatically sealed for 100 years.

Sealing of court records, however, does not absolutely ensure privacy. In one quite notable example, consider the very public divorce of prominent Chicago politician, Jack Ryan and his Hollywood wife, Jeri Lynn Ryan. The court agreed to seal the court records, but he was running for the U.S. Senate, and the Chicago Tribune gained access to the proceedings under the Freedom of Information Act, and they divulged sordid details about Jack Ryan going to sex clubs around the world. Due to pressure from the public and the Republican Party, Jack Ryan dropped out of the 2004 Senate race, and his opponent, a relatively unknown politician named Barack Obama, sailed to victory. Interestingly, in the Democratic primary, Barack Obama's opponent was Blair Hull, who may also have been brought down by the Tribune's FOIA request that unsealed his divorce records that showed that his wife had obtained a protective order alleging physical abuse. The lack of privacy in those cases may have changed the world.

(3) **Document Filing Strategies**. Filing only certain documents with the court or taking measures to protect the parties' identities may be possible in some proceedings. California permits divorcing spouses to execute two property settlement agreements, one that is filed with the court and one that is not. The unfiled agreement contains provisions that spouses wish to keep confidential. The court incorporates the unfiled agreement by reference and merges its provisions into the court's judgment, ordering the parties to comply with the terms of the unfiled agreement, but the unfiled agreement is not retained as part of the court records.

(4) **Making Criminal Records Confidential**. Two options are available in most jurisdictions for limiting public access to criminal records: (1) expungement (the actual legal term is "expunction"), sometimes allowed only if the defendant was not convicted, or for certain misdemeanor convictions (requirements can include completing probation or maintaining a clean record for a certain period of time); and sealing the criminal record by obtaining an order of non-disclosure.

I. **Securing Privacy at Death**. High-profile individuals may want to appoint a spokesperson to communicate on behalf of the decedent's surviving family members.

(1) **Death Certificate**. Most states require reporting a decedent's death to local and state authorities through filing a death certificate.

(2) **Funeral Arrangements**. Maintaining privacy in funeral arrangements may be difficult. Places of worship typically do not restrict people from attending the service (if the funeral will be held at a place of worship), and burial services in a public cemetery are obviously public. Individuals may choose to hold a private ceremony for family and close personal friends, with a separate public memorial service.

(3) **Obituaries.** To have some degree of control of what goes in an obituary, a client may consider writing his or her own obituary or providing a draft that can be updated at the client's death. High-profile clients may have multiple obituaries or "dueling" obituaries. As an example –

> In a somewhat awkward case, the wife and girlfriend of a deceased man wrote competing obituaries that appeared side-by-side in a local newspaper. One obituary stated that the decedent "[was] survived by his loving wife." The other obituary, placed directly below the first, made no mention of the wife, but noted that the decedent was survived by "his long-time girlfriend." Hillary Hansen, *Deceased Man's Wife and Girlfriend Write Competing Obituaries*,

HUFFINGTON POST, August 6, 2016, available at **http://www.huffingtonpost.com/entry/wife-girlfriend-write-obituaries-newpaper_us_57a5f548e4b021fd9878c5e3**

(4) **Last Medical Records**. HIPAA allows a decedent's personal representative to access medical records. A client may wish to obtain non-disclosure agreements from individuals who may get access to medical records after the client's death but who are not subject to HIPAA restrictions.

(5) **Autopsy Reports, Visual Evidence, and Vital Records**. Access to autopsy reports, photos, death certificates, and other vital records is governed by state law, which varies widely. Various states have laws governing the disclosure of crime scene photos, autopsy reports, and 911 transcripts, sometimes limiting access to next of kin.

m. **Cybersecurity**.

(1) **Password Protection.** Complex passwords obviously offer greater protection.

> Suppose a client's password is "Spartacus" in reference to his dog—a hacker can instantly crack this password. If the client adds some numbers to the password, so the password is "Spartacus12," a hacker can crack this password in roughly 14 minutes. If the client adds numbers and a special character, so the password is "@Sparta12cus," a hacker will need approximately 275 days to crack it. Even better, if the password is "Sp@artacusWENT2T0wn," a hacker will need approximately 377 billion years to crack it.

(2) **Disposal of Electronic Devices**. As an example of the importance of properly disposing of electronic devices,

> a security software company purchased 20 phones on eBay. The prior owners had performed a factory reset, believing that pictures and personal information had been permanently deleted. The security company, however, was able to recover approximately 40,000 photographs, 750 emails, 250 contacts with names and addresses, and other files containing highly personal information. The Federal Trade Commission has a useful website that provides information regarding the disposal of electronic devices and securing online accounts. [Citations omitted]

(3) **Marketing Stolen Credit Cards.** An individual named Rescator is behind many of the high profile retail credit card breaches. He sells software to each purchaser for $2,500. A purchaser of the software will find some way to install it on a target company. Once the software is installed, it will begin collecting millions of stolen credit card numbers (and information affiliated with each number). Rescator creates a marketplace for the stolen card numbers. He will sell them on the "dark web" and keep 40% of the proceeds. Rescator provides two benefits to hackers who use his software to steal credit card numbers. (1) He provides a marketplace for the credit card numbers. The Department of Justice estimates that he is responsible for 85% of credit cards that are sold on the dark web. (2) More important, he is in Russia, so the credit card hacker gets big insulation between his crime and U.S. law enforcement, pretty much eliminating the risk of criminal prosecution.

Someone who wants to purchase stolen credit cards can go to the Rescator site on the dark web and find credit cards from around the world (but not Russia – "we don't want to offend our host"). The buyer can also choose the type of credit card (e.g., MasterCard), the model of credit card (e.g., a platinum card), whether it is a debit or credit card, the bank that issued the credit card, and the city and state of billing address of the credit card. (The city and state information is very important. Fraud detection departments for credit card companies are excellent at discovering fraudulent attempts to use credit cards in distant cities from where the user is located at a particular time.) For example, even in a small town with a population of 7,000, there may be almost 2,000 credit card numbers for sale from that small town. The magnetic strip on the card provides all information about the account, including the account number, account holder, expiration date, and service code (CVV). The card can be used unless it has been cancelled.

(4) **Dark Web.** Criminals make use of the "dark web," which was created by the U.S. Navy to hide military activity on the Internet; technology masks some of its activities on the Internet. Like some other things created by the military, the technology leaked to the public, and criminals now use it. Google indexes only 14% of the Internet, which is what the public generally uses. That's where we live. The balance is a much darker part of the Internet.

(5) **Zeus**. Mark Lanterman (Minnetonka, Minnesota) was called into a case in which a family office accused a bookkeeper of wiring almost $1 million to Romania the prior day. The bookkeeper denied doing it. In searching her computer, Mark was able to confirm the bookkeeper's story that she had used her RSA security token to check the bank account balance, took a break, and later looked at some pictures of wedding dresses. In the process of searching her computer, he discovered that the Zeus malware had been installed. He found that it had been installed earlier when she clicked a link in an email titled "Fraud Alert from FDIC." It alerted small companies to be on the lookout for counterfeit cashier's checks that are difficult to identify. "If you want to see what they look like, click here." When she clicked the link, Zeus was downloaded. (When Mark hovered the cursor over that link, he saw that it went to another Web server, not the FDIC.)

The Zeus malware does three things: (i) it logs all keystrokes; (ii) it takes a screenshot of whatever is on the monitor every 30 minutes; and (iii) when the browser is closed, the software identifies an encrypted data connection and keeps the browser open without the user's knowledge, allowing the hacker to take control (and in that family office's case, to wire transfers out of the bank account).

In that case, Mark worked with his contacts in the federal government, who contacted law enforcement in Romania. Police in Romania immediately talked with the branch manager of the bank where the funds were wired. He said that three people arrived yesterday asking him to initiate an outbound wire immediately. He replied that bank policy was that wires cannot be initiated within two hours of closing. One of them walked up to his face and said "my friend, initiate the wire transfer now. If you don't, your wife, Janet, and daughter, Anna, will regret the decision as long as they live." The highly nervous (at that point) manager got the account number and sent the wire. When he came to work the next morning, he received a notification that the wire transfer had been rejected. He had been so nervous when he sent the wire that he had written down two of the numbers incorrectly. He notified the customers, who said they would come back to the bank so the wire could be re-sent. The manager told the police that the men would be there in 45 minutes, and 45 minutes later, the bad guys were arrested – including a Ukrainian general – for stealing $952,800 from the Minneapolis organization.

(6) **Ethical Obligations Regarding Law Firm Data Breaches**. The ethical duties of competence and confidentiality require lawyers to take reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to a client's representation. MODEL RULES OF PROF'L CONDUCT §1.1 & 1.6(c). Furthermore, comment 8 to §1.1 requires that "[t]o maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, *including the benefits and risks associated with relevant technology*." (emphasis added). Merely having a technology breach is not an ethical violation, the issue is whether the attorney took reasonable steps to prevent it. Factors include the level of sensitivity of information, the nature of clients, the likelihood of disclosure if protective steps are not taken, the cost of protective steps, the difficulty of implementing safeguards, and the likelihood that implementing a safeguard would adversely impact the ability to represent clients. If a data breach occurs, the attorney may be required to disclose the breach to the client under the ethical duty of communication (see Rule 1.4 of the Model Rules).

n. **Personal Security**. Many high profile clients don't consider personal security issues. Executives of large companies do, but not others. Planners can demonstrate value to clients by introducing them to these important issues.

Planning considerations and alternatives include –

1. maintain a low profile (be wary of posting personal information, travel schedules, etc. on social media; use aliases to obfuscate who is going to dinner or using football tickets, etc.);
2. home security systems ranging from inexpensive to complex and costly, and can include safe rooms (not like "panic rooms" in the movies, but it could be just a small bathroom or closet configured in the right way with bullet and bomb-proof walls, doors and windows, stocked with supplies to maintain the family for several days or more);
3. background investigations of potential and existing employees ("investigations" differ from "background checks," which can be purchased on the Internet for $19);
4. adopt appropriate policies and procedures, such as having required background investigations (insiders are the greatest personal threats to families, they have great access and tremendous authority); and
5. engage personal services, drivers, and bodyguards for higher security risk situations.

o. **Assessment by Professional Security Services Firm**. A professional securities firm can provide an overall security assessment, with customized recommendations dealing with a comprehensive set of risks, including natural disasters, medical issues, insider threats, external threats, criminal activity, terrorism, activists, or state actors. The analysis would include (1) an assessment of the current situation, (2) the design of a program to address specific risks as desired by the client (which risks could include people, property, information, reputation, or privacy), (3) implementing countermeasures (possibilities include executive protection, counter surveillance, intelligence, cyber/IT, technology, or adopting appropriate policies and procedures; using appropriate manpower is a key, to make sure that they are not insider threats), and (4) reviewing operations to assure that the system works for the family, and works as new situations arise (a child traveling to Europe, some children in college, etc.)

11. Improving GRAT Performance

The creative ideas (and forms) in this Item are from Carlyn McCaffrey (New York, New York). GRATs will continue to be a popular planning alternative in this period of legislative uncertainty. If the estate tax is repealed with a 10-year sunset provision, many clients will continue to engage in transfer planning for fear of the estate tax's return, but will want to avoid paying gift tax in doing so. If the gift tax remains, clients will still be interested in transferring wealth to the children, and the GRAT affords a very low-risk alternative. If the estate tax is replaced by a realization at death system, clients will continue to be motivated to shift appreciated assets out of the estate during life. The GRAT is particularly well-suited during this period of uncertainty in light of its tax certainty and the ability to assure that no gift taxes are incurred upon the creation of the GRAT.

a. **Drafting Techniques For Ensuring Regulatory Compliance**. The IRS has taken the position in some audits that transfers to the GRAT were taxable gifts in full (without being reduced by the value of annuity payments) if the actual administration of the GRAT failed to comply with regulatory requirements, by analogy to *Atkinson v. Commissioner*, 309 F.3d 1290 (11th Cir. 2002), *aff'g* 11 T.C. 26 (2000) (addressing a charitable remainder trust).

(1) **Late Annuity Payments**. Include a provision in the trust agreement causing the trust to terminate to the extent of a required payment if it is not made within the 105-day grace period allowed by the regulations.

> If any portion of an Annuity Payment has not been paid to the Settlor within one hundred five (105) days after the date the payment is required to be made (the "Relevant Annuity Payment Date"), a fractional portion of the Trust from which the Annuity Payment was required to have been made shall terminate and shall vest absolutely in the Settlor, or the Settlor's estate if the Settlor dies during the Trust Term. The fraction to be used to determine the portion of the Trust that terminates shall have a numerator equal to the amount of the Annuity Payment, and a denominator equal to the fair market value of the Trust Fund as finally determined for federal gift tax purposes on the Relevant Annuity Payment Date. The fractional portion is referred to as the "Terminated Portion." The Trustees shall have no further duties, power, authority or discretion to administer the Terminated Portion, notwithstanding any provision of this Trust Agreement or applicable law to the contrary. If the Terminated Portion remains in the hands of the Trustees after the Relevant Annuity Payment Date, the Trustees shall hold the property exclusively as nominees and agents for the Settlor or the Settlor's estate, to invest the Terminated Portion on behalf of the Settlor or the Settlor's estate with the same authority as the Settlor or the Settlor's Personal Representatives could individually. The Trustees, both as trustees and as nominees and agents, are relieved of any liability for commingling assets that have vested absolutely in the Settlor or the Settlor's estate, with assets that remain part of the Trust Fund.

(2) **Prohibition Against Additions**. The regulations prohibit additions to a GRAT. Include a clause providing that if the Settlor (inadvertently) makes an addition, the additional property will be held in a separate trust and not added to the initial GRAT.

> If the Settlor, after the Trust Creation Date, transfers property to the Trustees, the transferred property shall not be added to the Trust fund of the [NAME OF TRUST]. Instead, the Trustees shall hold the property in a separate Trust for the benefit of the Settlor and the Beneficiaries. The Trustees shall select a name for the Trust. The term of the separate Trust shall commence on the date of the transfer and shall last until the day before the [second] anniversary of the date of the transfer. The Initial Annuity Payment and subsequent annuity payments shall be determined as provided in [Article ___].

b. **Drafting Technique for Reducing Valuation Risk – Defining the Annuity by Formula**. One of the huge advantages of GRATs is the regulatory authority to define the annuity by formula, which can provide assurance that no significant taxable gift will be made upon the creation of the GRAT. If the value of the asset contributed to the GRAT is adjusted, the annuity amount adjusts as well.

> The Initial Annuity Payment applicable to the [NAME OF TRUST] shall be an amount equal to the initial fair market value of the Trust Fund as finally determined for federal gift tax purposes multiplied by the <u>greater</u> of (i) that percent that, when increased by twenty (20%) percent each subsequent year in accordance with the provisions of subsection (1), results in the Settlor's right to receive the Annuity Payments having a value equal to NINETY-NINE and NINE-TENTHS (99.9%) of the initial fair market value of the Trust Fund of the Trust as finally determined for federal gift tax purposes or (ii) that percent that, when increased by twenty (20%) percent each subsequent year in accordance with the provisions of subsection (1), results in the Settlor's right to receive the Annuity Payments having a value equal to [1 HUNDRED THOUSAND DOLLARS ($100,000)].

c. **Drafting Techniques for Reducing Exposure to Economic Risk.** Structure the GRAT so that only a nominal taxable gift results. If a significant gift is made upon creating a GRAT, and if the GRAT assets fail to produce sufficient growth, all of the trust assets could end up being returned to the grantor, thereby wasting use of the gift exemption amount.

d. **Drafting Techniques for Reducing Mortality Risk**. If the Settlor dies before the stated termination date of the GRAT, a substantial portion or all of the GRAT assets will likely be included in the Settlor's estate.

(1) **Create Short-Term GRATs**. A smaller possibility exists that the grantor will die during the trust term if the term is shorter. For this reason, many planners use two-year GRATs (unless a good economic reason exists for using a longer term).

(2) **Qualify for Marital Deduction in Case Settlor Predeceases**. GRATs provide that any annuity payments unpaid by the date of the Settlor's death would be payable to the Settlor's estate (so that the present value of all annuity payments which are deducted in determining the amount of the taxable gift will approximate the value contributed to the GRAT). If only the annuity is bequeathed to the surviving spouse followed the Settlor's death, it will constitute a nondeductible terminable interest (§2056(b)(1)) and therefore not qualify for the marital deduction. To avoid this result, the trust document should give the Settlor a power of appointment over the remainder interest that is includable in the predeceasing Settlor's estate, which the Settlor could exercise in favor of the surviving spouse. Because the spouse receives both the annuity and the remainder interest, it should no longer be a nondeductible terminable interest.

If the Settlor wants to use a QTIP trust for the surviving spouse, and if the annuity and remainder are left to the marital deduction trust, the trust agreement should provide that all income earned by the GRAT (even if in excess of the annuity amount) must be distributed following the Settlor's death if the annuity payments are to be made to a marital trust.

(3) **Sell GRAT Remainder When Contributing Existing Assets to GRAT.** Because §2036 contains an exception for transfers that are bona fide sales for full and adequate consideration, consider a transaction in which the Settlor contributes property to a GRAT equal to the present value of the annuity interest, and a pre-existing (old and cold) grantor trust contributes the value of the remainder interest. The IRS would likely argue that the adequacy of consideration for purposes of the §2036 exception must be measured against the full fair market value of property transferred, but recent cases have rejected this argument. *E.g., Estate of Magnin v. Commissioner*, 184 F.3d 1074 (9th Cir. 1999) (which also cites the earlier *Wheeler* and *D'Ambrosio* cases). Consider using a price adjustment clause or defined value clause to help assure that the proper value is paid for the remainder interest.

(4) **Joint Purchase When Acquiring New Asset.** If a new asset is being purchased, the Settlor and the remainder beneficiary could contribute amounts to the GRAT equal to the present values of the annuity and remainder interest, respectively. *See* Letter Ruling 9515039 (§2036 did not apply to joint purchase where obligation to pay annuity was guaranteed by the holder of the remainder interest).

(5) **Avoiding Income Tax Issue if Settlor Predeceases Annuity Term**. If the Settlor dies before the end of the initial term, the trust will no longer be a grantor trust. If the trust thereafter satisfies the right to receive pecuniary annuity amounts with appreciated assets, taxable gain can result (if not all of the trust assets are included in the Settlor's estate or if appreciation occurs after the Settlor's death, or if carryover basis is enacted). To avoid this result, the Settlor could bequeath the right to receive the remaining annuity payments to a trust that gives the GRAT the power to withdraw all of the new trust's assets. That should result in the new trust being a grantor trust as to the GRAT (see Item 22 below), so transfers between them should not be taxable events.

e. **Drafting Techniques for Enhancing Probability of Economic Success.**

(1) **Create Short-Term GRATs**. With a long-term GRAT, financial reversals in one year may offset all of the gains in other years. With a series of short-term GRATs, perhaps only the particular GRAT with the year of the financial reversal would be unsuccessful.

(2) **Use Decreasing Annuity Amounts.** The annuity amounts may be structured to be dramatically reduced after the first year's payment (for example, about 10% of the first year annuity payment). The effect, in large part, is to turn the GRAT into a one year trust. (The much smaller annuity amount in the second year will likely not eliminate substantial appreciation that occurs in the first year if the assets decline in value in the second year. Furthermore, a substantially lower amount would be included in the decedent's gross estate under §2036 if the grantor dies during the second year, thus reducing the mortality risk of the GRAT beyond the first year.) Some respected law firms are typically drafting GRATs using this approach.

(3) **Use Increasing Annuity Amounts**. The flip side of using decreasing annuity amounts is to use increasing annuity amounts so that in-kind distributions in the early years will be much lower, allowing the (hopefully) appreciating asset to remain inside

the trust longer before it must be used in making in-kind annuity payments. The regulations permit the annuity amount to increase by up to 20% per year.

f. **Funding Techniques.**

(1) **Fund Separate GRATs With Separate Investments.** If separate investments are contributed into separate GRATs, financial losses in one GRAT would not offset the gains of other investments.

(2) **Fund GRAT With Fractional (or Discounted) Interests**. If the GRAT is funded with discounted assets, the annuity payments will be reduced as a result of the valuation discount. On the other hand, if the payments can be made in cash rather than in-kind with the discounted assets, the arbitrage can almost guarantee a successful GRAT.

(3) **Funding a GRAT With Leveraged Assets**. The GRAT could be funded with an entity that is leveraged, resulting in a low net value of the interest in the entity contributed to the GRAT (with corresponding low annuity payments) as compared to the high gross value of assets in the entity. This leverage can increase the likelihood of having a hugely successful GRAT. (Stacy Eastland describes this planning alternative as a "LAGRAT" (leveraged asset GRAT).)

A simple straightforward method of introducing leverage would be for the GRAT to borrow as much as possible and invest the borrowed proceeds in assets with appreciation potential. Borrowing would increase the possibility of "hitting a home run" but would also increase the economic risks for the family.

The following is an example of an alternative that reduces the economic risk to the family that is leveraged inside the family, without outside debt.

(1) The client might contribute $100,000 of marketable securities to a wholly-owned LLC, and might sell $900,000 of securities to the LLC in return for a 3-year $900,000 note.

(2) The net equity value of the LLC would equal the $1 million value of securities in the LLC less the $900,000 note, or $100,000.

(3) The capital interest in the LLC (having a net value, without considering any discounts, equal to 10% of the value of the total LLC assets) would be contributed to a 3-year GRAT. Because of the 9-to-1 leverage of the LLC, if the $1 million of securities grow at 10%, substantial value would remain in the GRAT at the end of 3 years.

The results may be even better if a minority interest in a family investment entity is contributed to the LLC, resulting in discounting as well as the leverage.

This is somewhat comparable to a combined gift and sale to grantor trust transaction. The leveraged GRAT is better in that the client does not have to use up any significant amount of gift exemption. If the assets do not perform, nothing is transferred to family members via the GRAT, but no gift exemption is wasted (which can occur under a sale to grantor trust transaction if the assets in the grantor trust decline below the amount of the note). A potential concern with the leveraged GRAT alternative is whether the IRS might attempt to combine the note payment stream from the LLC and the GRAT annuity payment stream as part of an overall single transaction, and treat the client has having a continuing retained equity interest for purposes of §2036 in the interest that passes following the termination of the GRAT.

(4) **Funding a GRAT with Preferred Interests**. The GRAT might be funded with preferred interests in a partnership. If the preferred interest represents a large percentage (say 80 or 90%) of the value of the partnership, the preference return might have to be 8-10% for the preferred interest to be worth its face value. (The small "coverage" that exists in the partnership for being able to make the payments on the preferred interest makes the preferred interest more risky, therefore requiring a higher coupon rate to be worth face value.) Contributing the preferred interest (with its high coupon rate) to a GRAT assures the success of the GRAT if the partnership is able to make the preferred payments. Furthermore, an old and cold GST exempt trust could contribute to the partnership to receive the common interest so that growth above the coupon rate would be in a GST exempt format.

g. **Administration Techniques**. GRATs take close "care and feeding;" steps taken in the administration can help assure their success.

(1) **GRAT With Negative Performing Assets**. If the GRAT experiences losses in the early years, the Settlor might purchase the remaining assets and transfer them into a new GRAT. (The Settlor could even use a note to purchase the assets, which the GRAT would use to make annuity payments. That would not violate the prohibition against a GRAT issuing a note to pay annuity amounts under Reg. §25.2702-3(b)(1)(i).) With a fresh start, the new GRAT would have a higher likelihood of succeeding.

(2) **GRAT With Positive Performing Assets**. Similarly, if a GRAT has substantial gains in early years, the Settlor might purchase those assets to avoid the risk of later reversals, and assuring that assets would remain in the GRAT at the end of the initial term.

(3) **GRAT With Obvious Mortality Risk**. If a serious concern arises concerning whether the Settlor will survive the GRAT term, the Settlor could purchase the remainder interest from the remainder beneficiary for its then present value. If the remainder interest is owned by a grantor trust, the transaction would not be a taxable event. If the Settlor dies during the term, the trust assets would be included in the Settlor's estate, but the amount that had been paid for the remainder interest would have been removed from the estate. A concern with this approach is that Reg. §25.2702-3(d)(5) requires that GRAT instruments prohibit commutation, and the IRS might argue that the purchase of the remainder interest is, in effect, a commutation; which could result in the Settlor not having retained a qualified annuity interest at the outset.

h. "**Safety Valve" Measures Regarding Remainder Amount Passing to Descendants.** A parent may own assets that might explode in value (such as stock in a company that may go public in the near future). The parent may be willing to transfer a substantial part of the increase in value, but be leery of transferring "too much value" to his or her children. The GRAT could be structured to provide that the first $X of value at the end of the GRAT term would pass to a continuing grantor trust for children, and that any excess value in excess of $X would be returned to the grantor. Alternatively, the parent may want to be assured of receiving the first $X of value, with the remaining value passing to a trust for children or perhaps being split in some manner between the grantor and the children.

An example in the regulations makes clear that the annuitant may retain a contingent reversionary interest although such a contingent reversionary interest will be valued at zero for purposes of determining the amount of the gift. Treas. Reg. § 25.2702-3(e) Ex. 1.

In light of the ability to "zero-out" a GRAT under the *Walton* case, the donor has not used any gift exemption by reason of creating the GRAT. Accordingly, there is no particular tax "inefficiency" by having excess value over a specified target amount being returned to the grantor.

This added flexibility is even more apparent if a GRAT is compared to a sale to grantor trust transaction. Assume that parent owns an asset that may realize very large appreciation in future years (such as with an IPO or sale of a company). An inherent uncertainty with the sale approach is knowing how much to sell to the grantor trust in order to transfer a targeted desired amount to trusts for younger generations—because the result depends in large part on how much appreciation will occur in the transferred asset.

In addition, using a GRAT may allow the owner to be more aggressive in transferring a substantial part of a highly appreciating asset to the GRAT, because the grantor can retain the right to receive a certain amount of the trust assets at the end of the GRAT term.

12. Installment Sales to Grantor Trusts; Settlement of *Woelbing* Cases

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

The IRS and Treasury have expressed their discomfort with sale to grantor trust transactions by making dramatic legislative proposals in the 2013 and 2014 Administration’s Revenue Proposals (narrowed in the 2014 Proposal to target sale to grantor trust transactions specifically).

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

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

b. **Gift Tax**. The major gift tax issue is the value of the property that is sold. The IRS may also question the value of the note or argue that the note is valued at zero for gift tax purposes under §2702 (or perhaps under §2701) or because it is not a bona fide debt transaction.

The IRS may also argue that gifts and sales to the trust should be aggregated for valuation purposes if they are made in close proximity to each other. *See Pierre v. Commissioner* (T.C. Memo 2010-106). The sale should be made some time after the "seed gift." John Porter suggests 30 days should suffice, but 60 days is better, and the next tax year is better yet.

c. **Estate Tax**. Traditionally, the IRS has not argued that §2036 applies to sales to grantor trusts (and many sale transactions have been through audits without the IRS making that argument). However, the IRS argued that §2036 applies and the assets that were sold should be brought back into the seller's estate in the *Woelbing* cases, which have now been settled as discussed below.

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

(2) **Planning Regarding §2036.** To help in defending against a §2036 argument for sales to grantor trusts, John Porter suggests (1) that the partnership distributions should not be made at the same time and in the same amounts as the note payments, and (2) separating the gift and sale so that the taxpayer can argue that the sale transaction is for full and adequate consideration and that the full consideration exception to §2036 applies.

(3) **Repay Note Before Death.** If the note is repaid by the trustee before the seller's death, §2036 should not apply (and indeed §2035 should not apply even if the note is repaid within 3 years of death because the grantor/seller is not affirmatively relinquishing any deemed "retained interest;" it is the trustee that took the action to pay off the note).

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

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

In 2006, Mr. Woelbing sold that number of shares of non-voting stock in Carma Laboratories (a closely-held company located in Wisconsin) having a value of $59 million to his grantor trust in return for a $59 million note. The IRS questioned the value of the assets and the value of the note for gift tax purposes. It also argued that the stock was includable in the estate under §§2036 and 2038.

A stipulated decision was entered in the cases in March, 2016 resulting in no additional gift tax for Donald or Marian Woelbing's estate and no additional estate tax for Mr. Woelbing's estate. Attorneys involved in the case report that the IRS recognized the "Wandry-like" provision in the sales agreement (selling that number of shares equal to $59 million), and that §§2702, 2036, and 2038 did not apply because 10% equity existed in the grantor trust that purchased the shares. The result apparently is that more shares were retained by Donald, and passed from his estate to Marian (qualifying for the marital deduction at Donald's death). The settlement likely included an agreement of the additional shares that were included in Marion's estate, and the date of death valuation of those shares–even though the pending Tax Court cases does not address her estate tax.

The IRS made a similar §2036 attack on a sale of limited partnership interests to grantor trusts in *Estate of Beyer*. The Tax Court held that the FLP assets were included in estate the without specifically addressing the sale transaction. *Estate of Beyer v. Commissioner,* T.C. Memo. 2016-183.

e. **Planning Implications for Sales to Grantor Trusts.** For a more detailed discussion of the *Woelbing* cases and planning implications for sale to grantor trust transactions, see Item 11 of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

f. **Alternative to Sale to Grantor Trust Using Single Member LLC**. Stacy Eastland (Houston, Texas) suggests the possibility of using a single member LLC as an alternative to a sale to grantor trust. The client would contribute assets to a single member LLC in return for managing and non-managing interests and a note for about 90% of the value contributed. (Preferably, another grantor trust would also make a small contribution so the entity would still be disregarded for tax purposes but would have two members for state law purposes.) After some period of time, in a separate distinct and independent transaction, the client would give a 99% non-managing member interest to a grantor trust, valued at approximately 10% of the total assets in the LLC with appropriate lack of control and marketability discounts. The debt that leverages the transaction is inside the entity rather than being represented by a note from the grantor trust itself. This results in a tougher argument for the IRS to argue that the grantor has retained an interest in assets that were transferred to the grantor trust, because the grantor is not retaining the note in the course of making a transfer to the trust. (If the IRS succeeds in recharacterizing the note from the LLC as equity, it is just an equity interest in the LLC and not a retained interest in the grantor trust.) The economics are the same, however, as a sale to a grantor trust with a 9-1 debt to equity ratio. (Another advantage to this approach is that the pass-through treatment of the LLC could easily be avoided by merely admitting another person [not a grantor trust] to the LLC, meaning that it would no longer be a disregarded entity. In some circumstances, that might be easier than "turning off" grantor trust status in a sale to grantor trust transaction.)

13. Self-Canceling Installment Notes (SCINs); *Estate of William Davidson*; *Estate of Johnson*

a. **Brief Background.** A potential disadvantage of a basic intra-family installment sale or sale to a grantor trust is the potential inclusion, in the seller's estate, of the unpaid obligation at its fair market value on the date of the seller's death. One way to avoid this problem is to use a self-canceling installment note (SCIN), a debt obligation containing a provision canceling any future payments upon the death of the holder. Planning with self-canceling installment notes (SCINs) followed the seminal case of *Estate of Moss v. Commissioner.* 74 T.C. 1239 (1980), *acq. in result*, 1981-1 C.B. 2. The Tax Court held that the remaining payments that would have been due following the maker's death under a SCIN were not includable in the decedent's gross estate under §2033 because "[t]he cancellation provision was part of the bargained for consideration provided by decedent for the purchase of the stock" and as such "it was an integral provision of the note." Another potential advantage is that the SCIN may assist in the qualifying for §6166 deferral (by not having to include the balance of the note in the seller's estate, the likelihood of the remaining closely held business interest meeting the 35% of the adjusted gross estate requirement is enhanced).

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

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

b. ***Estate of William Davidson v. Commissioner*, Tax Court Cause No. 013748-13 (filed June 14, 2013).**

General Background. The decedent (age 86) entered into various gift and sale transactions in December 2008 and January 2009, including large sale transactions for self-canceling installment notes. Soon after these transactions, he was diagnosed with a serious illness and he died on March 13, 2009 before he received any payments on the notes. The case involved a wide variety of issues, but the major issues were valuation and whether the self-canceling installment notes constituted bona fide consideration that is considered as providing any value whatsoever, or if they are bona fide, whether they provide consideration equal in value to the stock transferred in return for the notes The IRS expressed its positions regarding this case in CCA 201330033.

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

Applicability of §7520 in Valuing SCINs. The IRS also argued that §7520 does not apply in valuing SCINs, reasoning that §7520 does not apply to SCINs because §7520 applies only in valuing annuities and life estates. The estate maintained that §7520 applies in valuing "any interest for life or a term of years," and that a SCIN requires valuing an interest that involves both a term of years and an interest for life.

Settlement of Tax Case. A stipulated decision was entered on July 6, 2015. The total deficiencies were over several hundred million dollars (but much lower than the amount of deficiency alleged in the Notice of Deficiency of over $2.6 billion).

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

The malpractice lawsuit was dismissed on August 11, 2016, primarily because the claims were time-barred under the one-year contractual limitations period imposed on asserting claims under the engagement letter, which stated that "[n]o action, regardless of form, relating to this engagement, may be brought by either party more than one year after the cause of action has accrued … " The opinion reasoned that New York law recognizes that parties "may contractually agree to shorten the applicable period of limitations … [and malpractice] claims stemming from the provision of tax advice accrue at the time the advice is given." The fraud claim accrued at the time plaintiffs possessed knowledge of facts from which the fraud could have been discovered with reasonable diligence, but Deloitte advised the clients in April 2009 that the IRS would likely challenge the estate plan transactions.

The estate has appealed that decision (filing its notice of appeal on September 13, 2016).

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

and Item 14 of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**. For a more detailed discussion of the facts that were alleged in the malpractice case (and that likely summarizes the weaknesses that the IRS emphasized in the settlement discussions), see Item 12 of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

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

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

The case also involved $10 million and $5 million life insurance policies financed by a third-party lender and a private split-dollar arrangement.

That case has now been settled, very largely in the taxpayer's favor. The IRS settled for a $969,761 deficiency in a stipulated decision entered in the Tax Court on August 30, 2017. *See* Erin McManus, *former Bookkeeper's Estate Mostly Wins on Complex Plan,* BNA Daily Tax Report (September 1, 2017). (The estate was represented by Gregory Densen and Christopher Cole, Denver, Colorado).

14. Defined Value Clauses; Attack on "Wandry" Clause in *Estate of True v. Commissioner*

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

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

(2) Formula allocation clause, allocating portions of a transferred asset between taxable and non-taxable transfers based on values as finally determined for federal gift tax purposes (*Christiansen, Petter*; both were full Tax Court cases approving these clauses and they were affirmed by the Eighth and Ninth Circuits, respectively);

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

(4) Price adjustment clause (*King;* but *McLendon* and *Harwood* did not recognize price adjustment clauses; an advantage of price adjustment clauses is that a "re-transfer/re-titling" of assets is not required after the correct value is determined); and

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

General Observations.

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

b. **2015-2016 Treasury Priority Guidance Plan Project**. The 2015-2016 Priority Guidance Plan (sometimes referred to as the IRS's "Business Plan") added the following item: "Guidance on the gift tax effect of defined value formula clauses under §2612 and 2511." See Item 5 above. Apparently, the IRS is adding a regulations project to address defined value formula clauses.

c. **Structuring Allocation Clauses**. Formula allocation clauses are supported by more judicial authority if the portion passing as a non-taxable transfer passes to charity. The "excess" value could pass to a public charity-donor advised fund (to avoid complex self-dealing and excess business holdings issues for private foundations). Other possible "pour-over" non-taxable recipients could include a surviving spouse, QTIP trusts or GRATs. If a QTIP trust or GRAT is used for the non-taxable portion of the transfer, the best approach is to use different trustees and somewhat different beneficial interests compared to the trust that receives the taxable portion of the transfer.

d. **Compliance Best Practices**. If a clause is used that is based on values as finally determined for federal gift tax purposes, a federal gift tax return must be filed reporting the formula transfer, or else a final determination of the gift tax value will never arise. The transaction should be reported on the gift tax return consistent with the formula transfer, providing that all that was transferred is the amount determined by the formula, but the units are initially allocated based on values as reflected in an attached appraisal.

e. **Wandry Clauses**. The *Wandry* case recognized a gift of that number of LLC units having a particular fair market value for federal gift tax purposes. *Wandry v. Commissioner*, T.C. Memo 2012-88, *nonacq. I.R.B. 2012-46.* That is obviously a much simpler transaction than a formula allocation clause approach, but so far, *Wandry* is the only case that has recognized its validity.

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

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

f. **IRS Attack on Wandry Clauses in *Estate of True v. Commissioner.***

(1) **Synopsis of *True v. Commissioner.*** IRS officials have been saying for several years informally that the IRS is still looking for the "right case" to mount another attack on *Wandry* clauses. Apparently, this is that case.

In this pending case, Mr. True made gifts of interests in a family business to one of his daughters and made sales of the business interests to all of his children and a trust. The transfers were made based on an appraisal from a recognized reputable national appraisal firm. The transfers to his children were subject to a "transfer agreement" with a defined value/price adjustment provision. The spouses made the split gift election, so any gift was made one-half by each spouse; hence separate Tax Court petitions for Mr. and Mrs. True.

A gift of units in the family business was made to one daughter (Barbara True), and the transfer agreement provided that if the transfer of those interests is determined for federal gift tax purposes to be worth more than the anticipated $34,044,838 amount of the gift, "(i) the ownership interest gifted would be adjusted so that the value of the gift remained at $34,044,838, and (ii) Barbara True would be treated as having purchased the ownership interests that were removed from her gift."

Sales of business interests were made to that daughter, the other two children, and a trust. According to the petition, the transfer agreement for the sales to his children "provided that if it is determined for federal gift tax purposes that the interests sold were undervalued by FMV Opinions, the purchase price would be increased to reflect the finally-determined fair market values."

The IRS has alleged a gift tax deficiency of $16,591,418 by each of Mr. and Mrs. True. The taxpayers contend that the valuations were correct, but if the transferred interests are determined to have a higher value, no gift should result because of the price adjustment provisions in the transfer agreement. *Karen S. True v. Commissioner,* Tax Court Docket No. 21896-16, and *H.A. True III v. Commissioner*, Tax Court Docket No. 21897-16 (petitions filed October 11, 2016).

For a further discussion of details about the *True* cases and planning implications for defined value clauses, see Item 31 of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

(2) **Good Faith Independent Appraisal**. An IRS concern with defined value types of clauses is that they may encourage taxpayers to use aggressively (and perhaps abusively) low valuations. If the IRS audits the transfer, the worse that happens is to accomplish a transfer of what should have happened in the first place – without any gift tax risk. If there is no audit, the taxpayer "gets away with murder." The *True* cases, on the other hand, involve a taxpayer who hired a reputable national appraisal firm to appraise the shares, and the transfers were made based on the appraisal.

(3) **"The Right Case."** The IRS informally has indicated that it has not given up on its opposition to *Wandry*-type clauses and is still looking for "**the right case**." That the IRS chose the *True* cases as the next vehicle to fight the *Wandry* clause is somewhat surprising. First, the cases involve transfers based on a reputable appraisal; one might have expected the "right case" to be one in which abusive extremely "low ball" figures were used without an appraisal and with the adjustment clause being used as a "backstop" in case the IRS audited the transaction. Second, the case will be appealable to the 10th Circuit Court of Appeals. The clauses for both the gift and sales transactions in the *True* cases involve a price adjustment clause, and the 10th Circuit has already approved price adjustment clauses in the gift tax context in *King v. United States* (albeit 40 years ago). Third, the case does not involve a situation in which "excess" transferred units are re-transferred back to the donor/seller, which would have most closely paralleled the "condition subsequent" analysis in *Procter*.

15. Family Limited Partnership and LLC Planning Developments; *Purdue, Holliday, Beyer, Powell* Cases

a. **Overview of §2036 Issues**. The most litigated issue is whether assets contributed to an FLP/LLC should be included in the estate under §2036 (without a discount regarding restrictions applicable to the limited partnership interest). About 39 reported cases have arisen.

(1) **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 government wins about 2/3 of those cases. (In some of those cases, the FLP/LLC assets have been included in the estate under §2036 even though the decedent had transferred the partnership interests during life (*Harper, Korby*).)

Bona Fide Sale for Full Consideration Defense. Almost every one of these cases that the taxpayer has won was based on the bona fide sale for full consideration exception to §2036. (The two exceptions are *Kelly* and *Mirowski,* which held that no retained enjoyment under §2036(a)(1) applied as to gifts of limited partnership interests.) The key is whether "legitimate and significant nontax reasons" existed for using the entity. Having tax reasons for creating entities is fine, but the test is whether "**a**" legitimate and significant nontax reason applied as well. For a listing (with case citations) of factors have been recognized in particular situations as constituting such a legitimate nontax reason and see Item 8.g of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

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

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

As discussed in *Strangi*, §2036(a)(2) applies even if the decedent is just a co-general partner or manager, but as a practical matter, the IRS does not view co-manager situations as critically as if the decedent was the sole manager. Having co-managers also typically helps support the nontax reasons for the partnership or LLC.

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

c. **Chart of FLP/LLC Discounts.** John Porter has prepared a helpful chart summarizing the discounts that have been recognized in cases involving FLP or LLC interests. See the Appendix of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

d. ***Purdue v. Commissioner* – LLC Assets Not Included Under §2036, Annual Exclusion, Graegin Loan**. *Purdue v. Commissioner*, T.C. Memo. 2015-249, addresses three of the issues "on the IRS radar" that frequently arise in estate and gift tax audits. (1) The decedent and her husband transferred marketable securities, an undivided interest in a building, and several other assets to an LLC in 2000. (2) The decedent made annual gifts of LLC interests to a Crummey trust in 2002-2007. (3) Following the decedent's death in 2007, the estate beneficiaries made a loan to the estate to pay the estate taxes and the estate deducted the interest payments as an administration expense for estate tax purposes.

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

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

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

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

(3) **Deductibility of Interest on Loan to Pay Estate Tax.** Interest on the loan from some of the estate beneficiaries to the estate to pay estate taxes was deductible as an administration expense for estate tax purposes. The loan was bona fide and it was "necessary" because one of the decedent's daughters (who was a member of the LLC) refused to consent to a large distribution from the LLC to pay the decedent's estate taxes, and the operating agreement required the LLC members to act unanimously in making decisions.

(4) **Detailed Summary** For a detailed summary of the *Purdue* case, see Item 10 of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

e. ***Holliday v. Commissioner* – FLP Assets Included Under §2036(a)(1).** In contrast to *Purdue,* there were no legitimate and significant reasons for creating an FLP in *Estate of Holliday v. Commissioner*, T.C. Memo 2016-51. The decedent contributed $5.9 million of marketable securities to the partnership. On that same day, she sold to her sons all of her membership interest in the LLC that was the general partner of the partnership and gave a 10% limited partnership interest to an irrevocable trust. She retained significant assets outside the partnership. The partnership made one relatively small ($35,000) pro rata distribution. She died two years later, and her estate claimed a 40% discount for her remaining 89.9% limited partnership interest. The assets were included in the estate under §2036 without a discount.

(1) **Implied Agreement of Retained Enjoyment**. The decedent by implied agreement retained possession or enjoyment of, or the right to income from the assets transferred to the partnership. The court emphasized that the partnership agreement required the distribution of "Distributable Cash" (in excess of its current operating needs) on a periodic basis, and found from the son's testimony "that had decedent required a distribution, one would have been made."

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

(2) **No Bona Fide Sale for Full Consideration**. The court concluded that three nontax reasons asserted for creating the partnership were not legitimate and significant. (1) Protection from "extortion by trial attorneys" – the decedent had never been sued; because she lived in a nursing home her risk of vulnerability to trial attorney extortion was minimal; and she retained significant assets that could be reached by someone trying to extort something from her. (2) Protecting against undue influence of caregivers – while caregivers had taken advantage of or stolen from other family members, the decedent's situation was different because her sons managed her affairs and visited her often; this concern was not discussed with the decedent when the partnership was formed, and there was no evidence she was concerned about undue influence from a caregiver. (3) Preservation of assets for the decedent's heirs – other structures for preserving assets were "quickly dismissed" because they were difficult to manage, but that was unconvincing because the

decedent’s previously deceased husband’s assets were being managed in trusts without difficulty; also the decedent was not involved in selecting the structure used to preserve her assets.

(3) **Not Arm’s Length, Formalities Not Followed, No Active Management**. The court also mentioned several other factors that had been raised by the IRS.

- The decedent “stood on both sides of the transaction” and it was not an arm’s-length transaction because there was no meaningful negotiation or bargaining associated with the transaction. [Planners argue that this “standing on both sides” argument should have no relevance because a transfer is “bona fide” as long as it is real and not a sham regardless of third party negotiation, but since this argument was first included in a case years ago, it gets repeated in almost every FLP §2036 case. Its relevance was severely questioned in *Purdue* (as discussed above).]
- Various formalities were not followed including the absence of books and records other than brokerage statements, formal meetings were not held and minutes were not kept, the requirement under the agreement to make distributions was not followed, and compensation was not paid to the general partner as required under the agreement.
- The marketable securities were not actively managed and were only traded on limited occasions. [The absence of any activity in the partnership gave the appearance that assets were transferred to the partnership merely to get a valuation discount.]

f. ***Beyer v. Commissioner* – FLP Assets Included Under §2036**. In *Beyer v. Commissioner*, T.C. Memo. 2016-183, the decedent transferred much of his assets to a revocable trust in 1999. The decedent created two other revocable trusts in 2003, which created a family limited partnership (the FLP); the “Management Trust” was the 1% general partner interest, and the “Living Trust” was the 99% limited partner. Six months later (April 2004), the decedent as trustee of his 1999 Trust transferred most of his assets (other than $4 million) to the FLP.

About a year after that, the decedent created an irrevocable grantor trust (the Grantor Trust) with $10. Eight months later (in December 2005) the Living Trust sold its entire 99% limited partner interest to the Grantor Trust for a secured note (when the Grantor Trust still only owned $10). The FLP’s income tax returns for 2005 and 2006 failed to recognize the Grantor Trust as the owner of the limited partnership interest. (Amended returns were filed correcting this mistake after the decedent’s death.)

In the meantime, the FLP had entered into a restricted management agreement as to 75% of its assets with an investment advisor, restricting any withdrawals from the account for four years.

The decedent made contributions to various Section 529 accounts in 2002 and 2005, intending to make the “five-year averaging” election, but failing to file a gift return for 2002 and failing to check the box to make the election on the 2005 gift tax return.

The decedent died in 2007.

The FLP made various distributions directly for the decedent's benefit, including almost $660,000 in 2006 to pay gift taxes, and a payment directly to the IRS for the decedent's estate taxes (even though neither the decedent nor the Living Trust owned the 99% limited partnership interest at those times).

Section 2036. The court determined that all of the FLP assets were included in the decedent's estate under §2036(a)(1). The bona fide sale for full consideration exception to §2036 did not apply. The transfers to the FLP were not bona fide because the purported nontax reasons for the trust were not recognized as the actual legitimate purposes for which the FLP was created. (These included keeping the Abbott stock and investment portfolio intact, providing management transition, and providing continuity of management.) Furthermore, the "full consideration" requirement was not satisfied because of the failure to maintain proper capital accounts. The decedent had an implied agreement of retained enjoyment, based primarily on the actual distributions made to the decedent and for the decedent's estate and because the decedent had not retained sufficient assets to satisfy his anticipated financial obligations. The *Beyer* case involved a massive failure of following formalities, and one suspects this failure to respect the partnership may have had a significant impact on the credibility of the position that the partnership was created for legitimate and significant nontax purposes.

Restricted Management Account. No discount was permitted for the restricted management account, because the account manager was not prohibited from selling assets (which does not make sense, because the reason for a discount is that the *owner* cannot access the account).

Section 529 Account Averaging. The decedent was treated as making gifts of the full amounts contributed to the Section 529 accounts in the 2002 and 2005 because the five-year election was not properly made. Failure to file and pay penalties were imposed for the 2002 gifts because no gift tax return was filed (until after the decedent's death), and accuracy related penalties for negligence were applied for the 2005 gifts that were not reported on the 2005 gift tax return. The reasonable cause exception to these penalties did not apply because the decedent did not seek qualified professional advice about filing gift tax returns or making the five-year averaging election.

For a more detailed analysis of *Beyer*, a listing of the many ways that the parties failed to follow formalities, and a planning checklist for structuring the proper formalities for FLPs and LLCs, see Item 29 of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

g. ***Estate of Powell v. Commissioner* – FLP Assets Includable Under §2036(a)(2)**. *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (May 18, 2017) is a "reviewed" Tax Court decision that may be the most important Tax Court case addressing FLPs and LLCs since the *Bongard* case (124 T.C. 95 (2005)) 12 years ago. The Tax Court breaks new ground (1) in extending the application of §2036(a)(2) to decedents owning only limited partnership interests, and (2) in raising the risk of double inclusion of assets under §2036 *and* a partnership interest under §2033, which may (in the court's own words) result in "duplicative transfer tax." (The case was decided on cross motions for summary judgement, and is not an opinion following a trial.)

The facts involve "aggressive deathbed tax planning," and the fact that the taxpayer lost the case is no surprise. But the court's extension of the application of §2036(a)(2) and the extensive discussion of possible double inclusion for assets contributed to an FLP or LLC are quite surprising (but whether a majority of the judges would apply the double inclusion analysis is not clear).

The decedent's son, acting in her behalf under a power of attorney, contributed about $10 million of cash and marketable securities to a limited partnership (FLP) in return for a 99% limited partnership (LP) interest. Her two sons contributed unsecured notes in return for the 1% general partner (GP) interest. The partnership agreement allowed for the partnership's dissolution with the written consent of all partners. The same day, the son who was the agent under the power of attorney (acting under the power of attorney) transferred the decedent's 99% LP interest to a charitable lead annuity trust (CLAT) paying an annuity to charity for the decedent's life with the remainder passing to the decedent's two sons (the remainder was valued by assuming a 25% discount for lack of control and marketability of the 99% LP interest). (A problem with the transfer to the CLAT is that the power of attorney only authorized gifts to the principal's issue up to the federal gift tax annual exclusion amount. (The taxpayer argued that gifts were authorized under the power of attorney under general state case law where the gifts were consistent with the estate plan.)

The decedent died 7 days later. [Counsel has indicated that the decedent was recovering nicely from a broken hip, and the CLAT was planned (and a medical opinion was received reflecting a greater than 50% likelihood of surviving a year) during that recovery, but the decedent contracted an infection after she had been cleared for a hospital discharge and died shortly thereafter from ensuing sepsis. At the time the FLP was funded and the CLAT was funded, counsel indicates that the serious infection had not yet occurred and the decedent was expected to be discharged from the hospital.]

The IRS claimed that the $10 million of assets contributed to the FLP were includible in the decedent's estate (without a discount) under §§2036(a)(1) (retained enjoyment or income), 2036(a)(2) (retained right in conjunction with any person to designate who could enjoy the property or its income), or 2038 (power to alter, amend, revoke, or terminate the transfer at the decedent's death), or under §2035(a) (transfer of property within three years of death that otherwise would have been included in the estate under §§2036-2038 or 2042) if the transfer to the CLAT was valid. The case indicates that the taxpayer did not contest the application of §2036(a)(2) [counsel has reportedly stated that he did *not* concede that issue], or contest that the bona fide sale for full consideration exception to §2036 was not applicable. The taxpayer argued that §§2036 and 2038 could not apply because the decedent no longer owned the LP interest at her death (despite the fact that the interest had been transferred within 3 years of her death and §2035(a) would then apply).

Counsel has indicated that the parties attempted to settle the case. Even when the taxpayer agreed to settle with no estate discount but not paying gift tax with respect to the CLAT transfer, in making the estate calculation the IRS treated the gift to the CLAT as an adjusted taxable gift that was added back to the tentative tax base (despite the express provision in §2001(b) that "gifts includible in the gross estate" are not treated as adjusted taxable gifts for this purpose). The taxpayer ultimately concluded that it had to file a Tax Court petition in order to get the estate tax calculation error corrected.

Section 2036(a)(2) Issue

The majority and concurring opinions both agreed that §2036(a)(2) applied (though the concurring opinion did not address the reasoning for applying §2036(a)(2)). The majority opinion reasoned (1) that the decedent, in conjunction with all the other partners, could dissolve the partnership, and (2) that the decedent, through her son as the GP and as her agent, could control the amount and timing of distributions. The opinion adopted the analysis in *Strangi* as to why the "fiduciary duty" analysis in the Supreme Court *Byrum* case does not apply to avoid inclusion under §2036(a)(2) under the facts of this case because any such fiduciary duty is "illusory."

The §2036(a)(2) issue is infrequently addressed by the courts; it has only been applied with any significant analysis in four prior cases (*Kimbell* and *Mirowski* [holding that §2036(a)(2) did not apply], and *Strangi* and *Turner* [holding that §2036(a)(2) did apply]). In both *Strangi* and *Turner*, the decedent was a general partner (or owned a 50% interest in the corporate general partner). *Powell* is the **first case to apply §2036(a)(2) when the decedent merely owned a limited partnership interest**. In this case the decedent owned a 99% LP interest, but the court's analysis drew no distinction between owning a 99% or 1% LP interest; the court reasoned that the LP "in conjunction with" all of the other partners could dissolve the partnership at any time. (Whether the court would have applied §2036(a)(2) had the decedent owned only a small LP interest is not known, but the court's reasoning does not draw any distinction based on the amount of LP interest owned by the decedent.)

Because §2036(a)(2) applied, the court did not address §2036(a)(1) or §2038.

"Double Inclusion" Issue

The majority opinion raised, on its own with no argument or briefing from any party, how §2036 or §2038 operate in conjunction with §2043 ostensibly to avoid double inclusion. The consideration received in return for the contribution to the FLP (i.e. the 99% LP interest) is subtracted under §2043 from the amount included in the gross estate under §2036. In effect, the value of the discount is included under §2036/2043 (i.e., the value of the assets contributed to the FLP minus the value of the 99% LP interest considering lack of control and marketability discounts). The opinion refers to this amount as the "doughnut hole." In addition, the 99% LP interest itself is included in the gross estate (if the gift is not authorized under the power of attorney) or is included in the gift amount if the gift is recognized, and the court referred to this as the "doughnut." That analysis avoids double inclusion IF the assets have not appreciated (and because the decedent died only 7 days later, the parties stipulated that the contribution values were also the date of death values). But if the assets have appreciated, footnote 7 of the "majority" opinion acknowledges that "duplicative transfer tax" would apply because the date of death asset value is included in the gross estate under §2036 offset only by the *date of contribution* discounted value of the partnership interest. The date of death value of the LP interest would also be included under §2033, so all of the post-contribution appreciation of the assets would be included under §2036 AND the discounted post-contribution appreciation also would be included under §2033. As a result, more value would be included in the gross estate than if the decedent had never contributed assets to the FLP. (Similarly, footnote 17 acknowledges that a "duplicative reduction" would result if the assets depreciated after being contributed to the FLP.) Whether a court would actually tax the same appreciation multiple times (or whether the IRS would even make that argument), in a case in which the majority's analysis is applied is (hopefully) doubtful, but the majority opinion did not even hint that the court would refuse to tax the same appreciation twice in that situation.

The concurring opinion (joined by seven judges) reasoned that the inclusion of the partnership assets in the gross estate under §2036 meant that the partnership interest itself was merely an alter ego of those same assets and should not also be included in the gross estate. That approach has been followed by the prior FLP cases in which §2036 was applied, and indeed even in this case the IRS did not argue that the asset value/partnership value should be included under both §2036 and §2033, offset by the partnership value at the date of the contribution. (That argument would have been meaningless in this case [because the date of contribution values and date of death values were the same], but the IRS has not made that argument in *any* other FLP cases even though substantial additional estate tax liability would have resulted in situations involving significant appreciation of partnership assets.)

The opinion leaves uncertainty, particularly as to the double inclusion issue, because the "majority" opinion (that espoused the double inclusion analysis) was joined by only 8 judges (one of whom was Judge Halpern, who is a Senior Judge and not one of the 16 current "regular" Tax Court judges), a concurring opinion (that rejected the double inclusion analysis) was joined by 7 judges, and 2 judges concurred in the majority opinion in result only.

The fact that eight judges adopted the double inclusion analysis may embolden the IRS to take that position in future cases, even though we do not yet know how a majority of the Tax Court judges would rule as to that issue. This raises a risk that contributing assets to an FLP (or for that matter, any entity) may leave a taxpayer in a significantly worse tax position than if the taxpayer merely retains the assets.

Rejection of Gift to CLAT

The court concluded that the gift to the CLAT was not valid, and therefore denied the IRS's additional gift tax deficiency and also the addition to the gross estate of additional gift tax on the gift made within three years of death.

Increased Significance of Bona Fide Sale for Full Consideration Exception

The combination of applying §2036(a)(2) even to retained *limited partnership* interests and the risk of "duplicative transfer tax" as to future appreciation in a partnership makes qualification for the bona fide sale for full consideration exception to §§2036 and 2038 especially important. In one respect, this means that *Powell* does not reflect a significant practical change for planners, because the §2036 exception has been the primary defense for any §2036 claim involving an FLP or LLC.

This case is appealable to the Ninth Circuit Court of Appeals, but is not being appealed.

Estate of Powell v. Commissioner, 148 T.C. No. 18 (May 18, 2017) (Halpern [Senior Judge], joined by Vasquez, Thornton, Holmes, Gustafason, Morrison, Buch, and Ashford, with Foley and Paris concurring in the result only) (concurring opinion by Lauber, joined by Marvel, Gale, Kerrigan, Nega, and Pugh).

For an excellent discussion of the *Powell* case, see Todd Angkatavanich, James Dougherty & Eric Fisher, Estate of Powell: *Stranger Than* Strangi *and Partially Fiction*, Tr. & Ests. 30 (Sept. 2017 and Mitchell M. Gans & Jonathan G. Blattmachr, *Family Limited Partnerships and Section 2036: Not Such a Good Fit*, 42 ACTEC L.J. 253 (Winter 2017).

Basic Facts

1. The decedent's son, as her attorney-in-fact under a power of attorney, contributed about $10 million of cash and marketable securities (managed by the son's wealth management firm) to an FLP on August 8, 2008 in return for a 99% LP interest. Two sons contributed unsecured promissory notes in return for a 1% GP interest.
2. The partnership agreement gave the GP the sole discretion to determine the amount and timing of distributions. In addition, the agreement permits the dissolution of the partnership with the consent of all partners (but even without that specific provision in the partnership agreement, all of the partners could get together at any time to dissolve the partnership or amend the agreement).
3. Also on August 8, 2008, the son as agent under a power of attorney transferred all of the decedent's 99% LP interest to a CLAT that would pay an annuity to charity for the decedent's life and pay the remainder to her two sons. The power of attorney, however, only authorized gifts to the decedent's issue "to the full extent of the federal annual gift tax exclusion." In determining value of the remainder interest gift that resulted from the creation of the CLAT, a 25% discount for lack of control and lack of marketability was used to value the 99% LP interest. The estate took the position on its gift tax return that the 99% limited partnership interest (valued at a 25% discount pursuant to a Duff & Phelps, LLC appraisal) was $7,516,773, and that the gift tax value of the remainder interest of the CLAT was equal to $1,661,422, thus reflecting that the actuarial value of the remainder interest was 22.1% of the value contributed to the CLAT.
4. The decedent died on August 15, 2008. [Counsel has reportedly indicated that the decedent was recovering nicely from a broken hip, and the CLAT was planned (and a medical opinion was received reflecting a greater than 50% likelihood of surviving a year) during that recovery, but the decedent contracted an infection after she had been cleared for a hospital discharge and died shortly thereafter from ensuing sepsis.]
5. The decedent and the son, who was the executor of the estate, resided in San Francisco when the petitions were filed (meaning that the case would be appealable to the Ninth Circuit Court of Appeals).

6. The IRS issued an estate tax notice of deficiency for about $5.88 million, resulting from an increase in the gross estate of $12.98 million ($10.02 million from the assets included under §2036 or §2038 and $2.96 million from additional gift tax resulting from the gift to the CLAT that would be includable under §2035(b) -- but for some reason without allowing an additional deduction under §2053(a)(3) for the additional gift tax [see footnote 12 of the opinion]).

   The IRS also issued a gift tax notice of deficiency for $2.96 million as a result of the creation of the CLAT (determining the gift amount using a 15% discount rather than a 25% discount in valuing the 99% LP interest) and treating the decedent as being terminally ill when the gift was made. The IRS valued the 99% limited partnership interest at $8,518,993 (applying a 15% discount) and valued the remainder interest in the CLAT at $8,363,095, thus reflecting that the actuarial value of the charitable interest (assuming the decedent was terminally ill) was only 1.56% of the value contributed to the CLAT.

7. Counsel has reportedly stated that the estate attempted to settle the case, agreeing with §2036 inclusion, but not having to pay any gift tax with respect to the CLAT transfer, but the IRS examining agent's calculations refused to reduce the amount of adjusted taxable gifts by the amount of the gifts included in the estate under §2036 in calculating the estate tax, as required by the last sentence of §2001(b).

8. The estate sought summary judgment that no estate or gift tax deficiency existed. The IRS moved for partial summary judgment that the value of assets contributed to the FLP is includable under §§2036(a)(1), §2036(a)(2), or 2038(a), or because the gift of the 99% LP interest to the CLAT was not authorized.

9. The case indicates that the taxpayer did not contest the application of §2036(a)(2) [counsel has reportedly stated that he did *not* concede that issue], or contest that the bona fide sale for full consideration exception to §2036 was not applicable.

Analysis – Majority Opinion

1. **Failure to Contest That Section 2036(a)(2) "Right to Designate" Elements Apply and That the Bona Fide for Full Consideration Exception Does Not Apply**. The estate did not refute the IRS argument that the "right to designate" requirements in §2036(a)(2) are satisfied or that the bona fide sale for full consideration exception to §2036 does not apply. The estate merely argued that §§2036 and 2038 could not apply because the decedent no longer owned the LP interest at her death (despite the fact that the interest had been transferred within 3 years of her death and §2035(a) would then apply).

2. **Section 2035**. In light of the estate's argument that the decedent no longer owned any interest in the FLP at her death, the opinion analyzes whether estate inclusion results even if the gift to the CLAT was valid (despite that the gift exceeded the agent's authority under the power of attorney). Section 2035(a) provides that if a decedent makes a transfer or relinquishes a power over property within three years of death and if the property would have been included in the decedent's gross estate under §§2036-2038 or §2042 at her death if the transfer had not been made, the value of any property that would

have been so included is included in the gross estate under §2035. Therefore, if §2036(a)(2) would apply if the decedent had still owned the LP interests at her death, the property contributed to the partnership would be included in the decedent's estate under §2035 if the gift is valid because the gift was made within three years of her death.

3. **Section 2036(a)(2) Applies**. Section 2036(a)(2) provides that if the decedent has made a transfer of property (other than a bona fide sale for adequate and full consideration), the property is included in the decedent's gross estate if the decedent controlled "the right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the property or the income therefrom." The IRS argues that the decedent transferred property to the FLP and that the decedent still had the ability to designate who could possess or enjoy the property or its income.

   The court in *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145, *aff'd*, 417 F.3d 468 (5th Cir. 2005) held that §2036(a)(2) (as well as §2036(a)(1)) applied to a situation in which the taxpayer's son funded an FLP on behalf of the taxpayer, with the taxpayer owning a 99% limited partnership interest and owning 47% of an S corporation that was the 1% general partner. The *Powell* majority opinion adopted the analysis from *Strangi*, both in reasoning why §2036(a)(2) applies and why the *Byrum* Supreme Court holding (discussed in Paragraph 4 below) should be distinguished. (While the Fifth Circuit affirmed the *Strangi* case, it did not address the §2036(a)(2) issue, finding that inclusion under §2036(a)(1) was sufficient to dispose of the case.)

   Powell concluded that if the decedent owned the LP interest at her death, §2036(a)(2) would apply for two different reasons. First, the decedent, in conjunction with the other partners, could all agree together to dissolve the partnership at any time. That would revest the property in decedent and she could then designate who could enjoy the property or its income. That alone is "sufficient to invoke section 2036(a)(2)," but the court also applied a second reason (also used in *Strangi).* Second, the decedent had the right, through her son who was a general partner and her agent under the power of attorney, to determine the amount and timing of distributions. The court pointed out similarities with the *Strangi* facts and reasoning [but the opinion failed to mention that part of the analysis in *Strangi* was that the decedent in the *Strangi* case also owned 47% of the corporate general partner and that the *Strangi* court made reference to the powers of the general partner].

4. "**Fiduciary Duty" Limitation on Applicability of Section 2036(a)(2) Under *Byrum* Is Distinguished.** The U.S. Supreme Court held in *United States v. Byrum*, 408 U.S. 125 (1972) that retaining the right to vote shares of stock in corporations that a decedent had transferred to a trust did not require that the shares be included in his estate under §2036(a)(2). In *Strangi,* the estate argued that if the mere fact that a decedent "could band together with all of the other shareholders of a corporation" is sufficient to cause inclusion under §2036(a)(2), the Supreme Court could not have reached its decision in *Byrum*. The estate in *Strangi* argued that the decedent's authority over the partnership, through her

son-in-law, was subject to state law fiduciary duties and therefore insufficient under *Byrum* to invoke §2036(a)(2). The *Strangi* court responded with an analysis of the additional constraints in *Byrum* that were not present under the *Strangi* facts. The *Powell* majority opinion adopted reasoning from *Strangi* to distinguish why the "fiduciary duty" analysis in *Byrum* did not apply under the facts of this case because any such fiduciary duty was "illusory."

- The son, in carrying out duties to the partnership as general partner, also owed duties to the decedent as her attorney-in-fact under the power of attorney and could not act in ways "that would have prejudiced decedent's interests." (In *Byrum*, dividend distributions would have been made to the trust, and distribution decisions from the trust were made by an independent trustee.)
- The decedent owned the 99% LP interest, so any fiduciary duties that limited the son's discretion as general partner in making partnership distributions "were duties that he owed almost exclusively to decedent herself." (*Strangi* had observed a distinction for "intrafamily fiduciary duties.")
- The FLP did not conduct meaningful business operations and was merely an investment vehicle for decedent and her sons. (*Strangi* concluded "Intrafamily fiduciary duties within an investment vehicle simply are not the equivalent in nature to the obligations created by the United States v. Byrum … scenario.")

5. **Limit Imposed by Section 2043 on Amount Includible Under Section 2036; "Double Inclusion" Issue.** The majority opinion, on its own without argument by any of the parties or any briefing, analyzed how §2036 is applied, in conjunction with §2043, in the context of assets contributed to an FLP (or LLC). The analysis is not central to the conclusion that §2036(a)(2) applies, and in that respect may be treated as dictum.

   If §2036 applies, the assets contributed to an FLP are included in the estate, but if the decedent continues to own the LP interest, that interest is also included under §2033 (according to the majority opinion), and the majority opinion has an extended analysis to explain why this does not result in "double inclusion." The majority opinion observes that prior cases have not articulated "the precise legal grounds that prevent such illogical 'double taxation'" from inclusion of "both the assets transferred to a family limited partnership and the partnership interest received in return." The majority opinion views this case as "the opportunity to fill that lacuna and explain why a double inclusion in a decedent's estate is not only illogical, it is not allowed." [For those, who like me, have no idea what a "lacuna" is, it is "an unfilled space or interval, a gap."]

   Section 2043 provides:

   > If any of the transfers, trusts, interests, rights, or powers enumerated and described in sections 2035 to 2038, inclusive, and section 2041 is made, created, exercised, or relinquished for a consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent.

Broken down in the context of assets contributed to an FLP that are included in a decedent's gross estate under §2036:

- If any transfer, interest, or power that would cause inclusion in the gross estate under §2036 is relinquished
- for consideration,
- but the consideration is not a bona fide sale for an adequate and full consideration (meaning that the "bona fide sale for full consideration" exception under §2036 does not apply to pre-empt the application of §2036),
- then the amount included under §2036 is reduced such that the amount included is
  - the fair market value, at the time of death, of the property that would otherwise be included, minus
  - the value of the consideration received for such relinquishment by the decedent.

The purpose of §2043(a) is to complement the bona fide sale exception in each of §§2035-2038. The bona fide sale exception limits the application of §§2035-2038 to transactions that deplete a decedent's estate. If some consideration is received, but not enough to prevent depletion of the estate, §2043(a) "limits the inclusionary rules so that they apply only to the extent necessary to prevent depletion of the transferor's estate." Section 2043(a) attempts "to provide a measure of relief from double taxation of the same economic interest" [quoting *Estate of Frothingham v. Commissioner*, 60 T.C. 211, 216 (1973)] and "limits the required inclusion to the amount by which the transfer depletes the decedent's estate."

In the context of applying §2036 to the transfer of the $10 million to the FLP by the decedent, the amount included under §2036 is "only the excess of the fair market value at the time of her death of the cash and securities transferred to [the FLP] over the value of the 99% limited partner interest in [the FLP] issued in exchange for those assets" (but footnote 7 observes that the reduction is just the value of the 99% LP interest "on the date of the transfer" of assets to the FLP). The bona fide sale exception under §2036 and 2038 with respect to transfers to an FLP has two requirements – (i) a bona fide sale (meaning "the existence of a legitimate and significant nontax reason for creating the family limited partnership") and (ii) adequate and full consideration (meaning "the transferors received partnership interests proportionate to the value of the property transferred") [footnote 6 quoting *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005)]. Under *Bongard*'s proportionality test for what satisfies the second "adequate and full consideration" prong, a transfer of assets to an FLP can be treated as being made for full consideration even if discounts for lack of control or marketability "cause the value of the partnership interest received by a decedent to be less than the value of the assets he transferred to the partnership." [Footnote 6] Therefore, transfers to an FLP can result in some depletion of the estate but only if the partnership was created for a legitimate and significant nontax reason, thus causing the exception under §2036 to prevent §2036 from applying. If the bona fide sale test is not met (i.e., if there is no legitimate and significant nontax reason for creating the partnership), the net effect is that §2036 as limited by §2043(a) "includes in the value of decedent's gross estate the amount of any discounts applicable in valuing the 99% limited partner's interest in [the FLP] issued in exchange for the cash and securities [assuming the assets have not appreciated] (an amount that could colloquially be characterized as the 'hole' in the doughnut)." The date of death value of the 99% LP interest itself, if still owned by the decedent, would be included in the gross estate under §2033 (or under the facts of *Powell,* if the transfer to the CLAT were either void or revocable, would be included under §2038).

Only one previous FLP Tax Court case (*Estate of Harper v.* Commissioner, T.C. Memo. 2002-121) that applied §2036 has addressed the impact of §2043(a), and the *Powell* majority opinion said it concluded that a partnership interest did not qualify as "consideration," for purposes of either section 2036(a) or section 2043(a), if the formation of the partnership did not involve a genuine pooling of assets, but is nothing other than circuitous "recycling of value" that does not "rise to the level of a payment of consideration."

The entire reference to §2043 in *Harper* is as follows: "Furthermore, although section 2043 can entitle taxpayers to an offset for partial consideration in cases where a transfer is otherwise subject to section 2036, this section, too, is inapplicable where, as here, there has been only a recycling of value and not a transfer for consideration." The majority opinion has an extended 8-page discussion to rebut the assertion that §2043(a) does not apply to FLP-§2036 transfers because of that one sentence statement in *Harper*. It concludes that the "pooling of assets" and "recycling of value" discussion in *Harper* "is more germane to the first prong (the bona fides of the transaction) than to the second (adequacy of consideration)" of the bona fide sale for full consideration exception in §2036. Similarly, a comment in *Estate of Thompson v. Commissioner*, T.C. Memo. 2002-246, *aff'd*, 382 F.3d 367 (3d Cir. 2004) that "the decedent's receipt of a partnership interest in exchange for his testamentary assets is not full and adequate consideration within the meaning of section 2036," was likely related to the bona fide sale prong of the §2036 exception, and the Third Circuit's affirmance "referred only to the absence of 'any valid, functioning business enterprise' rather than on the proportion of partnership assets contributed by the decedent."
[Observation: Despite the lengthy explanation and attempt to distinguish the statement in *Harper* that §2043(a) is inapplicable "where, as here, there has been only a recycling of value and not a transfer for consideration," the majority opinion's rationale that the "pooling" and "recycling of value" comments in *Harper* relate to the first leg of the bona fide sale for full consideration exception in §2036 does not explain why §2043(a) would not apply because §2043(a) makes no reference to the bona fides of the transaction.]

6. **Double Inclusion Issue; "Duplicative Transfer Tax" *Does* Exist to the Extent of Post-Contribution Appreciation.** The purpose of the court's lengthy discussion of the manner in which §2043 limits double taxation if §2036 includes assets contributed to a partnership AND the partnership interest itself also is

included in the estate is to demonstrate that double inclusion does not really result. (The majority opinion fills the "lacuna and explain[s] why a double inclusion in a decedent's estate is not only illogical, it is not allowed.") The majority opinion itself, however, acknowledges that "duplicative transfer tax" can result to the extent of post-contribution appreciation of assets in the FLP/LLC:

> Changes in the value of the transferred assets would affect the required inclusion because sec. 2036(a) includes in the value of decedent's gross estate the date-of-death value of those assets while sec. 2043(a) reduces the required inclusion by the **value of the partnership interest on the date of the transfer**. To the extent that any post-transfer increase in the value of the transferred assets is reflected in the value of the partnership interest the decedent received in return, the appreciation in the assets would generally be subject to a duplicative transfer tax. (Conversely, a post-transfer decrease in value would generally result in a duplicative reduction in transfer tax.) Footnote 7 (emphasis added).

The majority opinion's §2043(a) analysis avoids double taxation of the same value IF the assets have not appreciated (and because the decedent died only 7 days later, the parties stipulated that the contribution values were also the date of death values). But if the assets have appreciated, footnote 7 of the majority opinion acknowledges that "duplicative transfer tax" would apply because the date of death asset value is included in the gross estate under §2036 offset only by the *date of contribution* discounted value of the partnership interest. The date of death value of the LP interest also would be included under §2033, so all of the post-contribution appreciation of the assets would be included under §2036 AND the discounted post-contribution appreciation would also be included under §2033. More value may be included in the gross estate than if the decedent had never contributed assets to the FLP. (Similarly, footnote 17 acknowledges that a "duplicative reduction" would result if the assets depreciated after being contributed to the FLP.)

7. **No Consideration of §§2036(a)(1) or 2038(a)**. Because §2036(a)(2) applied, the majority opinion did not consider the arguments for inclusion under §§2036(a)(1) or 2038(a). [Observation: §2036(a)(1) may have been be a difficult argument for estate inclusion. All of the decedent's partnership interests were transferred to the CLAT with **no retained interest** for the decedent. If the decedent had retained substantial assets outside the FLP, the IRS may not have had a strong retained implied interest argument. Maybe that is why the court applied §2036(a)(2) and not §2036(a)(1).]

8. **Transfer to CLAT Void or Voidable; No Gift Deficiency.** The court ruled that the gift to the CLAT was not valid under the express terms of the power of attorney or under state law regarding the powers of agents. Because the gift of limited partnership interests to the CLAT was void or voidable, the government's allegation of a gift tax deficiency was denied. Therefore, the government's allegation that the additional gift tax should be included in the estate under §2035(b) was also denied, but the court observed in footnote 12 that including any additional gift tax in the gross estate under §2035(b) would have been offset by an equal additional debt deduction for the gift tax debt under §2053—which had not been addressed in the IRS Notice of Deficiency or in the IRS's trial

position. (The opinion did not observe whether the decedent had made sufficient prior gifts that a gift tax was paid regarding the gift to the CLAT and whether the estate had filed a proper claim for refund of such gift tax within the period for claiming refunds.)

Analysis – Concurring Opinion

1. **Aggressive Deathbed Tax Planning**. The concurring opinion viewed this as a case of "aggressive deathbed tax planning," and observed that the IRS "had available a number of theories on which to challenge the transactions."

2. **Possible Invalidity of Partnership.** A possible theory to challenge the transaction is that the "partnership was invalid ab initio" because "the other two supposed partners—her sons and heirs—contributed nothing more than unsecure promissory notes." The son, acting under a power of attorney, negotiated with himself, signing the partnership agreement as general partner and for his mother. The majority opinion does not address this "partnership invalidity" theory, perhaps because the IRS did not clearly articulate it and because it could require resolving disputed issues of fact which could preclude a summary judgment resolution of the case.

   Even if the partnership interest is recognized, the concurring opinion expresses skepticism that any lack of marketability discount would have been allowed. ("This theory validates the estate's claimed discount for lack of marketability, which seems highly suspect on the facts presented.")

3. **Section 2036(a)(2) Inclusion**. The concurring opinion also agrees that §2036(a)(2) applies. The concurring opinion's full discussion of why §2036(a)(2) applies is as follows:

   > The Court correctly concludes that section 2036(a)(2) applies here. [Citations to majority opinion page numbers and the *Strangi* case omitted] The decedent clearly "made a transfer" of the $10 million in cash and securities. And she clearly retained the proverbial "string" that pulls these assets back into her estate.

   This acknowledgement of the application of §2036(a)(2), however brief, is important, reflecting that 15 of the 17 judges participating in this decision explicitly recognized that §2036(a)(2) applies. (The other two judges concur in the result only of the majority opinion. Because the result is that the assets contributed to the partnership were included in the decedent's estate under §2036(a)(2) and on no other grounds, they must also have agreed that §2036(a)(2) applied.)

4. **Reject Double Inclusion Analysis.** "This is where I part company with the Court, because I do not see any 'double inclusion' problem." The concurring opinion disagrees with the court's analysis of including assets under §2036 (reduced by the discounted value of the partnership interest) AND also including the partnership interest itself under §2033. If the assets contributed to the partnership are included under §2036, the partnership interest itself should not also be included in the estate under §2033. "Once that $10 million is included in her gross estate under section 2036(a)(2), it seems perfectly reasonable to

regard the partnership interest as having no distinct value because it was an alter ego for the $10 million of cash and securities."

The concurring opinion points out that the "double inclusion limited by §2043" approach was not suggested by either party in the case and §2043 was not mentioned in either party's briefs. It observes that merely including assets under §2036 without also including the partnership interest in the gross estate under §2033 is the approach has been followed by all of the prior FLP/LLC cases that have applied §2036.

> The Court's exploration of section 2043(a) seems to me a solution in search of a problem. It is not necessary; the parties did not think it was necessary; and our prior cases show that it is unnecessary.

Furthermore, the concurring opinion questions whether §2043(a) would apply in this situation:

> And even if the section 2043 issue were properly presented, I am not sure the Court's application of that provision is correct. It is far from clear to me that the decedent's partnership interest--a consequence of the now-disregarded transfer—can constitute "consideration in money or money's worth" within the meaning of section 2043(a).

In support of the concern that §2043 might not apply in this situation, the concurring opinion cites the *Harper* and *Thompson* cases (discussed in the majority opinion) and *Estate of Gregory v. Commissioner*, 39 T.C. 1012, 1020 (1963) (holding that a decedent's retained interest in her own property cannot constitute consideration under section 2043(a)).

Also, the concurring opinion observes that the possibility of a "duplicative reduction in transfer tax" [to the extent of post-contribution *depreciation* of partnership assets] may invite overly aggressive tax planning." [Observation: That seems an overreach; no one would purposefully hold onto assets hoping that they would decline in value.]

Finally, the concurring opinion believes the new approach risks creating new problems and prefers following the approach used in all of the prior §2036 FLP/LLC cases:

> By adopting an untried new theory without first hearing from the parties, we risk creating problems that we do not yet know about. The more prudent (and conservative) approach in my view would be to adhere to the letter and spirit of our precedent, leaving the law in the relatively stable position that it appears to occupy now.

Observations

1. "**Overly Aggressive Deathbed Tax Planning."** The court's refusal to allow valuation discounts is not surprising. The case involves a number of bad (or at least suspicious) factors:

    - Funding of the entity only by the soon-to-be decedent;
    - With only cash and marketable securities;
    - A mere 7 days before death;
    - By the decedent's son acting under a power of attorney;

- With a subsequent transfer to a CLAT and a retained charitable annuity for the life of the apparently soon-to-die donor, resulting in a substantial value shift to the agent and his brother.

That the taxpayer lost the case is not surprising.

2. **Significant Extension of Application of §2036(a)(2) to Retained Limited Partnership Interests.** The §2036(a)(2) issue is addressed infrequently by the courts; it has been applied with any significant analysis in only four prior cases (*Kimbell* and *Mirowski* [holding that §2036(a)(2) did not apply], and *Strangi* and *Turner* [holding that §2036(a)(2) did apply]). In both *Strangi* and *Turner*, the decedent was a general partner (or owned a 47% interest in the corporate general partner). *Powell* is the **first case to apply §2036(a)(2) when the decedent merely owned a limited partnership interest**. In this case the decedent owned a 99% LP interest, but the court's analysis drew no express distinction between owning a 99% or 1% LP interest (although the distinction from *Byrum*'s limitation on the application of §2036(a)(2) because of fiduciary duties would not be as strong if other significant partnership interests existed, particularly if they were unrelated parties, and any fiduciary duties were not "owed to herself"). The court reasoned that the LP "in conjunction with" all of the other partners could dissolve the partnership at any time. (Whether the court would have applied §2036(a)(2) had the decedent owned only a small LP interest is not known, but the reasoning allowing the ability to dissolve the entity by acting "in conjunction with" other partners would not change based on the amount of LP interest owned by the decedent.)

   The net effect is that, under this analysis, §2036 will apply to almost all FLPs/LLCs, whether or not the client retains a general partner or managing member interest, unless the bona fide sale for full consideration exception to §2036 applies. Furthermore the same reasoning would seem to apply to practically any enterprise or investment involving other parties. For example, interests in C corporations, S corporations, or undivided interests in real estate would be subject to the same reasoning that the decedent could join with the other shareholders/co-owners (perhaps even if unrelated?) and dissolve the entity/co-ownership, with all parties receiving their pro rata share of the assets.

3. **Bad Facts Make Bad Law.** To a degree, this may be a "bad facts make bad law" case. The court may have stretched to find that §2036(a)(2) applied to avoid estate tax discounts for this deathbed transaction that lacked any non-tax purposes, even though the decedent received only limited partnership interests, because of the difficulty of applying §2036(a)(1) when the decedent did not intend to retain ANY interest in the FLP. A consideration of "sham transaction" or "void partnership" theories may have involved fact issues that would have precluded a summary judgment.

   The IRS's real concern is that the transaction was merely a gimmick to produce discounts and lacked economic substance, but the Tax Court had previously rejected the authority of the IRS to merely disregard transfers to partnerships because of the decedent's "subjective intentions" as long as the partnership was validly formed and changed relationships between the decedent and his heirs and creditors. *Estate of Strangi v. Commissioner*, 115 T.C. 478, 486-87, *rev'd on other grounds*, 293 F.3d 279 (5th Cir. 2002).

4. **Increased Significance of Bona Fide Sale for Full Consideration Exception to §2036.** The combination of applying §2036(a)(2) even to retained *limited partnership* interests and the risk of "duplicative transfer tax" as to future appreciation in a partnership makes qualification for the bona fide sale full consideration exception to §§2036 and 2038 especially important. Make sure that a legitimate and significant nontax purpose for creating the FLP/LLC exists to satisfy the bona fide prong of the exception, but also be sure that proper capital accounts are maintained to satisfy the full consideration prong of the exception as interpreted by *Stone*, *Kimbell* and *Bongard. See Estate of Beyer v. Commissioner,* T.C. Memo. 2016-183 (full consideration prong of §2036 exception did not apply because of the failure to maintain proper capital accounts).

   In one respect, this means that *Powell* does not reflect a significant practical change for planners, because the §2036 exception has been the primary defense for any §2036 claim involving any FLP or LLC. Almost all of the taxpayer victories against a §2036 claim have been based on the bona fide sale for full consideration exception to §2036. (Several exceptions are *Estate of Kelly v. Commissioner*, T.C. Memo. 2012-73 and *Estate of Mirowski v. Commissioner,* T.C. Memo. 2008-74, which both refused to apply §2036 to gift transactions that did not qualify for the full consideration exception. In addition, *Kimbell v. U.S.*, 371 F.3d 257, 268 (5th Cir. 2004), refused to apply §2036 to transfers to an LLC without addressing whether the bona fide sale for full consideration exception applied to those transfers.)

5. **Elimination of Unanimous Partner Approval Requirement for Dissolution**. The partnership agreement in this case "allows for the partnership's dissolution with the written consent of all partners." Would the omission of this explicit requirement of unanimous consent for dissolution in the partnership or LLC agreements provide an argument against applying §2036(a)(2) under *Powell?* That would provide a factual distinction from *Powell,* but the court's reasoning for applying §2036(a)(2) made no reference whatsoever to the unanimous consent requirement for dissolution in the partnership agreement. The court made reference various times to the decedent's "ability to dissolve" the partnership in conjunction with her sons, but never made reference to the fact that the partnership could *only* be dissolved with her consent.

   If the partnership agreement is silent regarding dissolution, the Revised Uniform Limited Partnership Act provides various events that can cause the dissolution of the limited partnership, one of which is "the affirmative vote or consent of all general partners and of limited partners owning a majority of the rights to receive distributions as limited partners at the time the vote or consent is to be effective." REV. UNIF. LTD. PTNSHIP. ACT §801(a)(2). If the decedent owns a majority of limited partnership interests, the decedent would have the ability to act with others to dissolve the partnership in any event under the Uniform Act (unless the partnership agreement negated that provision). This same provision is included in the California limited partnership act. CALIF CODE CORPORATIONS §15908.01.

If none of the permitted events that would cause dissolution of the partnership involve action by the limited partner, the argument that the decedent could dissolve the partnership in conjunction with others is more tenuous. For example, under the Revised Uniform Limited Partnership Act, if the partnership agreement does not address limited partnership consent regarding dissolution and if a decedent owned less than a majority of the limited partner interests entitled to distributions, the decedent would have no way to participate in the decision to dissolve the partnership. However, the decedent as a limited partner always could join with all the other partners to amend the partnership agreement and add provisions allowing the dissolution of the partnership. *Id.* at §406(b)(1) (affirmative vote or consent of all partners is required to amend the partnership agreement). If a court were inclined to employ common sense limitations in applying the "in conjunction with" phrase (see paragraph 17 below), the ability to join with other partners in amending the partnership agreement seems more remote than an explicit direct ability to join with others in dissolving the partnership.

Indeed, the court in footnote 4 suggests that the application of §2036(a)(2) might have been avoided by a change in drafting of the partnership agreement. (Footnote 4 includes the following clause: "had NHP's limited partnership agreement been drafted in a way that prevented the application of sec. 2036(a)(2).") How that drafting would have been accomplished under the court's reasoning is not clear. If the agreement had been silent regarding dissolution, the general partner and a majority of the limited partners (which would have included the decedent) could have dissolved the partnership under California law. Perhaps the court was suggesting that the partnership agreement could have been provided that the limited partners would have had no input into the decision to dissolve.)

6. **Avoid Having Decedent's Agent as General Partner**. One of the court's reasons for applying §2036(a)(2) was that the son could make distribution decisions and also owed duties to the decedent under the power of attorney from the decedent, thus she had the ability through her agent to determine the amount and timing of distributions. That argument could be removed by having someone serve as general partner other than the decedent or an agent for the decedent under a power of attorney

7. **Special Voting Interests to Make Liquidation/Dissolution Decisions**. One planning alternative may be to have a special partnership or member interest that would have the *exclusive* ability to vote on liquidation or dissolution decisions. The first rationale of the court's reasoning under §2036(a)(2) would then no longer apply—the decedent could not participate with anyone in deciding when to dissolve the partnership/LLC. That is not a complete answer to the court's reasoning however; under state law, all of the partners/members presumably could agree to change the underlying formation documents any way they wanted, including the omission of the special voting interest. But having

significant factual differences may be important if a court looks for ways to distinguish the *Powell* holding.

8. **Trust Owners With Independent Trustee.** If all of the partners/members were irrevocable trusts with independent trustees, any dissolution proceeds would pass to the irrevocable trusts, and the decedent could not join with the trustee in making distribution decisions, so the court's "in conjunction with" analysis would no longer give the decedent the ability to designate who could receive the income or property contributed to the partnership/LLC. The decedent's interest could be held in an "incomplete gift" trust (for example if the trust was for the sole benefit of the decedent and the decedent had a testamentary power of appointment), but most clients would likely not be willing to be subject to that inflexibility.
9. **Transfer All Interests During Life**. Some clients have created FLPs/LLCs with the contemplation that some or most of the limited partner/member interest would be retained until the client died, and valuation discounts would apply to those interests for estate tax purposes. In light of the result in *Powell* suggesting that §2036(a)(2) will always apply unless the bona fide sale for full exception is applicable, clients in the future may consider only contributing to entities an amount for which the client would contemplate eventually giving or selling all of the retained interests (and having the foresight to do so at least three years before death). Appropriate discounts should apply in valuing the gifts or in determining sale prices, and §2036 would not apply to include the entity's assets in the estate (without a discount) under §2036.
10. "**Claim Victory" and Dissolve FLP/LLC With Prior Successful Transfers**. If a client has previously created an FLP/LLC and has made gifts or sales of interests in the entity to trusts that have experienced substantial appreciation, consider dissolving the entity so that the trusts would own the value apart from the FLP/LLC, thus negating any possible §2036 taint. Value attributable to interests that have been transferred at least three years earlier should not be subject to §2036(a)(1) if no implied agreement of retained enjoyment exists (*see* the *Jorgenson*, *Kelly*, and *Rosen* cases), but §2036(a)(2) might continue to apply to gifts of interests over which the decedent has a continued ability (in conjunction with other) to determine the amount or timing of distributions.
11. **Rationale for Estate Inclusion for Basis Adjustment Purposes**. If a decedent dies without estate tax concerns and the estate would like to include the FLP assets in the estate without a discount for basis adjustment purposes, the *Powell* reasoning provides a rationale for including the assets in the estate (at least as to interests retained by the decedent or transferred within the prior three years) as long as the transfer to the partnership did not qualify for the bona fide sale for full consideration exception to §2036.
12. **Impact of Retaining 99% Limited Partnership Interest on §2036(a)(2) Analysis**. Is the extension of §2036(a)(2) to retained limited partnership interests related to the fact that the decedent held 99% of the LP interests? The majority opinion has two references to the retention of most of the interests in the partnership. First, retaining most of the partnership interests is a reason

that the *Byrum* opinion's discussion of fiduciary duties as a limitation of the application of §2036(a)(2) is not applicable because "any fiduciary duties … were duties he owed 'essentially to himself.'" The second reference addresses a concern that retaining almost all of the partnership interests could be a potential problem in applying the §2043 analysis and the double inclusion approach. Retaining most of the of partnership interests suggests no "pooling" of assets which some cases (including in Harper) cited as a reason that the bona fide sale for full consideration exception to §2036 does not apply. However, the court reasoned that the "degree of pooling is relevant to the question of the nontax bona fides of the transaction," not the degree to which "a partnership interest received in exchange for transferred assets should be treated as consideration received for those assets in applying section 2036(a) or section 2043(a)." The majority opinion reasoned that the "proportion of partnership assets contributed by the decedent" was not a factor in determining whether the receipt of a partnership interest could be treated as consideration under §2043(a).

The majority opinion has no discussion directly commenting on the decedent's retention of a 99% LP interest rather than a smaller interest as the reason that the court applied §2036(a)(2) to the retention of mere LP interests, or suggesting that the result would have been different if the decedent had retained a much lower LP interest. (Whatever LP percentage is retained could be used "in conjunction with any person" to dissolve the partnership.) One of the reasons given for rejecting the *Byrum* reasoning refusing to treat certain retained authorities as constituting retained "rights" because of fiduciary limitations was that any fiduciary duties were "illusory" because the duties were merely owed to Ms. Powell herself (as the 99% limited partner.) That is the only aspect of the analysis that suggests that retaining a large limited partnership interest versus a smaller interest would have an impact on the §2036(a)(2) analysis.

Contributing assets to an FLP/LLC in return for almost all of the interests may affect the "gut reaction" impact of viewing the transaction as mere paper shuffling by a decedent without any reasons for the contribution other than generating valuation discounts.

13. **Double Inclusion Analysis**. The majority opinion's summary of how §2043 applies in the context of §2036 FLP cases is similar to what Professor Jeffrey Pennell has been telling planners for the last decade. *See e.g.,* Pennell, *Recent Wealth Transfer Developments*, ABA REAL PROP., PROB. & TR. LAW SECTION 14TH ANN. EST. PL. SYMPOSIUM, at 21-23 (2003). Up to this point, however, the IRS and all of the prior §2036 FLP cases have avoided that technical analysis by merely including assets contributed to an FLP in the estate under §2036 and not *also* including the retained partnership interest itself in the estate under §2033. (Indeed, even in this case, the IRS did not argue that the assets should be included under §2036 and that the 99% interest should also be included under §2033 to the extent the transfer under the power of attorney was not valid (because gifts were authorized only up to the annual exclusion amount).

    The IRS has previously ruled that life insurance proceeds received by a partnership should be not includible in the gross estate *both* under §2042 and under §2033 as to the decedent's partnership interest under the reasoning that "unwarranted double taxation" would otherwise result. Rev. Rul. 1983-147 (quoted below). Similarly, the regulations regarding GRATS state that if the GRAT assets are included under §2036, the retained annuity interest payments that are payable after the decedent's death are not also included under §2033 "because they are properly reflected under this section." Reg. §20.2036-1(c)(1)(i).

Dictum. The analysis is not central to the conclusion that §2036(a)(2) applies, and in that respect may be treated as dictum.

Appreciation. The big distinction of applying the §2036/2043 and §2033 inclusion analysis is that future appreciation of assets contributed to the FLP/LLC will result in double taxation. See Paragraph 6 above of the Analysis of the Majority Opinion. More value may be included in the gross estate than if the decedent had never contributed assets to the FLP. That issue was not raised in this case, because the parties stipulated that the date of contribution value and the date of death value (7 days later) were the same. Whether a court would actually tax the same appreciation multiple times (or whether the IRS would even make that argument), in a case in which the majority's analysis is applied is (hopefully) doubtful. For example, in Revenue Ruling 1983-147, the IRS refused to include life insurance proceeds payable to a partnership both as part of a partner's interest in the partnership and under §2042 as a result of incidents of ownership attributed to the decedent as partner of the partnership, because doing so would result in "unwarranted double taxation":

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

Judge Counting. The *Powell* opinion was a plurality opinion in that the majority opinion was not joined in by a majority of the judges. Seven judges joined Judge Halpern's majority opinion espousing double inclusion with 2 judges concurring in result only. Six judges joined Judge Lauber's concurring opinion rejecting double inclusion. Therefore, the vote was 8-7-2, and Judge Halpern is a Senior Judge who is not one of the 16 "regular" Tax Court judges. Therefore, we do not yet know how a majority of the Tax Court judges would rule regarding the double inclusion issue.

Emboldened IRS? The fact that eight judges adopted the double inclusion analysis may embolden the IRS to take that position in future cases, even though we do not yet know how a majority of the Tax Court judges would rule as to that issue. This raises a risk that contributing assets to an FLP (or for that matter, any entity) may leave a taxpayer in a significantly worse tax position than if the taxpayer merely retains the assets.

14. **Reduced Emphasis on Not Retaining Any Interest as General Partner or Manager.** As a result of concerns raised by the *Strangi* and *Turner* cases applying §2036(a)(2) when the decedent held an interest as general partner or manager, planners have discouraged clients from keeping any interest as a general partner or manager of an FLP or LLC. If a client insists on having some participation in management of the FLP/LLC, planners have encouraged the client to minimize the interest as general partner or manager as much as possible. The importance of eliminating or minimizing management participation by the client may be reduced under *Powell*, to the extent it is interpreted as applying §2036(a)(2) in any event as long as the client continues to hold any limited partnership or member interest in the FLP/LLC. All seventeen of the judges participating in the *Powell* decision agreed that §2036(a)(2) should apply in a situation in which the decedent held NO interest as general partner. One possible approach in light of this result is to emphasize reliance on the bona fide sale for full consideration exception rather than avoiding "strings" that could trigger the application of §2036(a)(2). (However, the transferor's retention of substantial control of the FLP/LLC may color the court's perception of whether a legitimate and significant nontax reason existed for creating the FLP/LLC, depending on the nontax reasons for which the entity is created.)

15. **Basis Implications**. To the extent that partnership assets are included in a decedent's estate under §2036, the assets should receive a basis adjustment inside the partnership "to reflect the value of the property that was included in … the estate" even without a §754 election for the partnership. *Hurford Investments No 2, Ltd. v. Commissioner*, Tax Court Docket No. 23017-11 (Order dated April 17, 2017); Letter Ruling 200626003. *See* Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications*, ¶ II.Q.8.e.iii.(b) at 928 n.3635 (June 2017). Under the majority opinion's analysis, some of the partnership asset value will be included under §2036 (offset by §2043) and some will be included under §2033 (what the majority opinion refers to colloquially as the "donut"). Presumably, all of that value will result in a basis adjustment of the partnership's inside basis, but as to the portion represented by inclusion under §2033, a §754 election may be necessary.

16. **Summary of Practical Planning Implications**. Lou Harrison (Chicago, Illinois) provides an outstanding summary of the practical planning implications of *Powell*:

> The holding in the case is bad, but in many regards restates the Tax Court's antipathy toward sham partnerships. Essentially, the court expands the potential reach of 2036(a)(2) to just about any family partnership. This conclusion is a result of a limited partner's ability to participate in the liquidation decision of the partnership (and of course this will be based on what the default rule and state law provides).
>
> But do not fret. To get out of 2036, and therefore, to have the discount respected, the partnership can still fall within the "bona fide sale for an adequate and full consideration" exception. To be bona fide, the partnership has to have economic substance apart from the tax savings. In essence, then, the Court is merely restating its prior view and holding towards partnerships.

> In months to come, practitioners will slice and dice the meaning of this opinion in their various Planning Vegematics. But realistically, the court could have saved us a lot of agony by just saying what was on their mind, specifically: "A family partnership that is clearly a sham, such as a 99% retained marketable asset partnership, will not be respected for discounting purposes." But then again, if lawyers and courts could talk like most human beings, what would be the value of having law schools?
>
> The good news from this case is that a partnership that has economic substance will likely still enjoy the discounting benefit. Louis S. Harrison, *Stupid Is As Stupid Does: Does the* Powell *Case Spell The Demise of Discount Partnership Planning or Does It Merely Restate What We Already Know?* 20 J. PASSTHROUGH ENTITIES (July/Aug. 2017).

17. **Prior Cases That Have Limited the Broad Application of the "In Conjunction with" Phrase in §§2036 and 2038**. Section 2036(a)(2) was enacted with almost identical "in conjunction with" language as in §2038. Several §2038 cases have limited the application of this provision in determining whether a decedent held a joint power to terminate a trust. For example, a power conferred by state law to revoke or terminate a trust with the consent of all beneficiaries is not taxable. *Helvering v. Helmholz*, 296 U.S. 93 (1935), *aff'g* 75 F.2d 245 (D.C. Cir. 1934) (reasoning that this power exists under state law in almost all situations, and to hold otherwise would cause all trusts to be taxable). (This exception seems analogous to the power under state law of all partners to agree to amend the partnership agreement or to cause the liquidation of the partnership.) Another example is *Tully Estate v. Commissioner*, 528 F.2d 1401 (Ct. Cl. 1976). In *Tully*, decedent was a 50% shareholder. The corporation and decedent entered into a contract to pay a death benefit to the decedent's widow. Even though the beneficiary designation was irrevocable, the IRS argued that it could be amended for several reasons, including that the decedent and the other 50% shareholder could cause the corporation to agree with the decedent to change the beneficiary. The court's analysis is analogous to the broad extension of §2036(a)(2) to FLPs:

    > In light of the numerous cases where employee death benefit plans similar to the instant plan were held not includable in the employee's gross estate, we find that Congress did not intend the 'in conjunction' language of section 2038(a)(1) to extend to the mere possibility of bilateral contract modification. Therefore, merely because Tully might have changed the benefit plan 'in conjunction' with T & D and DiNapoli, the death benefits are not forced into Tully's gross estate. 528 F.2d at 1404-05.

    A possible distinction of applying the logic of these §2038 cases to the "in conjunction with" language in §2036(a)(2) is that the regulations under §2038 specifically state that a settlor's ability to act in concert with all donees/beneficiaries is not a retained power under §2038, but the analogous provisions in the regulations under §2036 regulations do not include that same statement. *See* Reg. §§20.2038-1(a)(2) (§2038 does not apply "[i]f the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law"); 20.2036-1(b)(3). However, applying the "in conjunction with" clause in a different manner in those two situations does not seem supportable under any policy rationale.

18. **Supreme Court's Refusal to Apply §2036(a)(2) in a Broad Manner in *U.S. v. Byrum*.** In *U.S. v. Byrum,* 408 U.S. 125 (1972), the Supreme Court held that a decedent's right to vote shares of stock in three corporations that he had

transferred to a trust for the benefit of his children did not cause the value of those shares to be included in the value of his estate under §2036(a)(2). The Court rejected the government's argument that the decedent's ability to vote the transferred shares gave the decedent the power to impact the corporation's dividend policy and thus the trust's income (or the trust beneficiaries' ability to enjoy the income). Section 2036(a)(2) requires that the decedent retained the "right" to designate who could enjoy the transferred property or its income, and *Byrum* reasoned that the term "right" "connotes an ascertainable and legally enforceable power," and the power to use the ability to vote the majority shares to influence corporate directors regarding the flow of dividends "was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term." The Court observed in footnote 14 of its opinion "that restraints on the exercise of power … deprive the person exercising the power of a 'right' to do so." Among other things, the Court noted that the decedent, as the controlling shareholder of each corporation, owed fiduciary duties to the minority shareholders that circumscribed his influence over the corporations' dividend policies. Furthermore, even if the corporation made dividend distributions, the trustee (not the decedent) would decide whether to make distributions to the trust beneficiaries.

The IRS's own published summary of *Byrum* is in Rev. Rul. 81-15, 1981-1 C.B. 457. That Revenue Ruling revoked 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). The prior Rev. Rul. was revoked in light of the *Byrum* case. The following is the complete discussion in Rev. Rul. 81-15 of the IRS's interpretation of the *Byrum* case:

> In *United States v. Byrum*, the Supreme Court addressed the issue of includibility of transferred stock where the decedent had transferred the stock in trust, retaining the right to vote the transferred shares, the right to veto the sale or acquisition of trust property and the right to replace the trustee.
>
> The court concluded that because of the fiduciary constraints imposed on corporate directors and controlling shareholders, the decedent "did not have an unconstrained *de facto* power to regulate the flow of dividends, much less the right to designate who was to enjoy the income." See *Byrum, supra* at 143.
>
> Thus, *Byrum* overruled the proposition on which Rev. Rul. 67-54 was based; that is, that a decedent's retention of voting control of a corporation, coupled with restrictions on the disposition of the stock, is equivalent to the right to designate the person who shall enjoy the income.

This statement was included in the Supreme Court's majority decision despite the Supreme Court's acknowledgement in footnote 25 that its conclusion was not based just on the premise that "the general fiduciary obligations of a director are sufficient to eliminate the power to designate with the meaning of §2036(a)(2)."

Revenue Ruling 81-15 has not been modified or withdrawn. Therefore, the most recent official guidance as to the interpretation of the *Byrum* case is "that *because of the fiduciary constraints imposed on corporate directors and controlling shareholders*, the decedent did not have an unconstrained de facto power to regulate the flow of dividends, much less the right to designate who was to enjoy the income." (Emphasis added). Furthermore, under CC-2003-014, Chief Counsel attorneys cannot argue contrary to "final guidance," which includes Revenue Rulings.

19. **Detailed Discussion of Prior FLP/LLC Cases That Have Addressed §2036(a)(2**). Four cases have addressed the application of §2036(a)(2) to FLP/LLC assets, *Kimbell, Strangi, Mirowski, and Turner.* These four prior cases are summarized in some detail below.

a. **IRS Previously Often Has Not Argued That §2036(a)(2) Applies.** As a practical matter, the IRS has not previously seemed to be pressing hard on §2036(a)(2) claims, but has generally attacked FLPs/LLCs using §2036(a)(1). For example, in *Mirowski v. Commissioner* the IRS did not even argue that the decedent's serving as the sole manager of the LLC by itself triggered §2036(a)(2). (Instead, the IRS tried to point to language in the agreement suggesting that the manager could make disproportionate distributions, and the court rejected even that argument and held that §2036(a)(2) did not apply to gifts of LLC member interests.) However, the IRS has sometimes made the §2036(a)(2) argument in addition to other arguments under §2036(a)(1).

b. ***Strangi v. Commissioner***. In *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-15, *aff'd*, 417 F.3d 468 (5th Cir. 2005), the Tax Court held that §2036(a)(1) applied and also held that §2036(a)(2) applied to transfers to the corporation that was the general partner and to the partnership. T.C. Memo 2003-145. (This is the Tax Court opinion on remand from the Fifth Circuit's initial decision in *Strangi*, directing the Tax Court to consider the §2036 issue.) Judge Cohen's discussion of §2036(a)(2) is the most expansive application of that section in any estate tax case up to that time, and drew considerable criticism from tax planners and academics. The Fifth Circuit's affirmance of *Strangi* did not address §2036(a)(2). (Because §2036(a)(1) applied, the court did not reach the alternative §2036(a)(2) issue.)

Factors Causing §2036(a)(2) Inclusion in *Strangi*. Judge Cohen analyzed in detail the facts of *Strangi* compared to the facts in the *Byrum* case. In *Strangi*, 98% of the decedent's wealth (about $10 million) was contributed to a partnership having a corporation as the 1% general partner and decedent as 99% limited partner. The corporation was owned 47% by the decedent, 52% by family members, and 1% by a charity (which the court ignored as de minimis).

Problematic Retained Powers. Judge Cohen concluded that the decedent retained legally enforceable rights to designate who shall enjoy property and income from the partnership and corporation. Judge Cohen emphasized that it is immaterial whether the documents and relationships create rights exercisable by decedent alone or in conjunction with other corporate shareholders and the corporation's president.

Partnership income — the agreement gave the general partner "sole discretion to determine distributions."

Partnership property — decedent can act together with the other shareholders to dissolve the partnership. (Under the partnership agreement, the partnership is dissolved by unanimous vote of limited partners and the general partner. Under the corporation's bylaws, all of the corporation's shareholders must consent to dissolution of the partnership. Thus, decedent could act in his capacity as a limited partner and shareholder with the other owners to dissolve the partnership.)

Corporation property and income (of the corporate general partner) — decedent "held the right, in conjunction with one or more other Stranco directors, to declare dividends."

"Banding together" is sufficient. Taxpayers argued that if the mere fact that a decedent "could band together with all of the other shareholders of a corporation" is sufficient to cause inclusion under §2036(a)(2), then the Supreme Court could not have reached its decision in *Byrum*. The court responded with an analysis of the additional constraints in *Byrum* that were not present in *Strangi*.

Comparison to *Byrum*. Judge Cohen pointed to various additional constraints upon "rights to designate" in *Byrum.* Commentators, however, suggest that the key rule from *Byrum* is the announcement of a bright-line test turning on whether the grantor's retained powers were legally enforceable. "The [Supreme] Court's ensuing discussion of the variety of constraints that typically narrow the scope of a majority shareholder's ability to control the flow of dividends was an explication of the rationale for its bright-line test, not a listing of elements that must be present in every case if the section is to be rendered inoperative." Gans & Blattmachr, Strangi*: A Critical Analysis and Planning Suggestions*, 100 TAX NOTES 1153, at 1157 (Sept. 1, 2003).

- **Independent Trustee.** In *Byrum*, the decedent retained the right to vote stock, which could be used to elect directors, who decided what distributions would be made from the corporation. However, the stock was given to a trust with an independent trustee who had the sole authority to pay or withhold income. Under the *Strangi* facts, distribution decisions were made by the corporate general partner.
- **Economic and Business Realities.** The flow of funds in *Byrum* was dependent on economic and business realities of small operating enterprises that impact the earnings and dividends. "These complexities do not apply to [the partnership or corporation], which held only monetary or investment assets."
- **Fiduciary Duties**. Judge Cohen distinguished fiduciary duties in *Byrum* because there were unrelated minority shareholders who could enforce these duties by suit. "Intrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the *United States v. Byrum*, *supra*, scenario."

"In Conjunction With" Broad Application. The court, to a larger extent than any previous §2036(a)(2) case, interpreted the "in conjunction with" language in the statute and regulations very broadly. The court's analysis, when pushed to its extreme, would mean that any family entity could be ignored under §2036(a)(2) because the decedent — regardless how small of an interest that the decedent held — would hold the power, "in conjunction with others" to vote its interest as a member of the entity (i) to affect indirectly when income distributions would be made, and (ii) to liquidate the entity and distribute its assets. An extension of this analysis could ultimately lead to negating any fractionalization discounts where family members hold the other interests in an asset. (For example, the taxpayer could act "in conjunction with" other family owners to sell the asset, thus avoiding or minimizing any minority or marketability discounts. This basically yields the result — under §2036 rather than under a valuation approach — that the Treasury Department has pushed in several different legislative sessions, but that has, so far, been rejected by Congress.) It seems very doubtful that courts will extend the application of §2036 in this manner to negate fractionalization discounts.

c. **Attempt in *Strangi* to Limit *Byrum*'s Fiduciary Duty Analysis If There Are No Unrelated Owners**. *Byrum* was decided against the backdrop of numerous cases that had established that §2036(a)(2) would not apply if the decedent had the discretion to make distributions that were limited by an ascertainable standard. The IRS issued Rev. Rul. 73-143, 1973-1 C.B. 407 soon after *Byrum* was decided. That Revenue Ruling explicitly agreed to an ascertainable standard exception to §2038 where the decedent could make distributions for the support and education of the beneficiary, even though only family members are beneficiaries. Further, the fact that other partners were family members should not diminish the importance of the fiduciary duties.

> …a fiduciary duty is no less constraining simply because it is owed to a family member…Most critical, the Service appears to have endorsed this reading of *Byrum* in a published ruling as well. In Rev. Rul. 81-15, invoking *Byrum's* fiduciary-duty analysis, the Service concluded that § 2036(a)(2) did not apply in the case of corporate stock where the decedent had retained voting rights even though the only shareholders were apparently the decedent and a family trust created by the decedent. Gans & Blattmachr, *Strangi: A Critical Analysis and Planning Suggestions*, 100 TAX NOTES 1153, at 1159 (Sept. 1, 2003).

The Tax Court has previously rejected arguments by the IRS that the presence of unrelated minority shareholders lent substance to the decedent's fiduciary duty that was critical to the outcome of the *Byrum* case. *Estate of Gilman v. Commissioner*, 65 T.C. 296 (1975), *aff'd per cur.*, 547 F.2d 32 (2nd Cir. 1976) (no estate inclusion; decedent was co-trustee with power to vote stock; there was active conduct of a business and 40% of voting shares of corporation were held by sisters and there was family disharmony); *Estate of Cohen*, 79 T.C. 1015 (1982) (§2036(a)(2) did not apply to decedent as co-trustee of a Massachusetts real estate trust; because courts hold business trustees to a "fair standard of conduct," and the decedent and his sons [as co-trustees] did not have the power to withhold dividends arbitrarily).

Holding that fiduciary duties provide a limit on the right to designate who enjoys or possesses transferred property only if there are unrelated persons who can enforce those duties is inconsistent with many cases that have held that very broad administrative powers retained by a donor as trustee do not invoke §2036, primarily because of the restriction imposed by the fiduciary duties that were legally enforceable. Those cases involve trust transactions that do not involve any unrelated parties. *E.g. Old Colony Trust Co. v. U.S.*, 423 F.2d 601, 603 (1st Cir. 1970) (broad trustee administrative powers that could "very substantially shift the economic benefits of the trust" did not invoke §2036(a)(2) because such powers were exercisable by the donor-trustee in the best interests of the trust and beneficiaries, and were subject to court review).

Judge Cohen's narrow interpretation of the *Byrum* case in *Strangi* is far more restrictive than the IRS's published position on *Byrum* in Rev. Rul. 81-15, 1981-1 C.B. 457 (quoted in Paragraph 16 above).

d. ***Kimbell v. U.S.*** *Kimbell v. U.S.* refused to apply §2036(a)(2) to include LLC assets in the decedent's gross estate. *Kimbell v. U.S.,* 371 F.3d 257, 268 (5th Cir. 2004), *rev'g,* 244 F. Supp. 2d 700 (N.D. Tx. 2003). The decedent formed an FLP, retaining 99% limited partnership interest. The 1% general partner was an LLC, owned 50% by the decedent (her son and daughter-in-law each owned 25%). The son was manager of the LLC. The court addressed whether assets contributed to the FLP and to the LLC should be included in the decedent's estate under §§2036(a)(1) or (a)(2).

The district court concluded that the bona fide sale for full consideration exception under §2036 did not apply and that the FLP assets were included in the decedent's estate under §§2036(a)(1) and 2036(a)(2). (The district court did not specifically address the reasons that §2036 applied to the LLC assets.) As to the §2036(a)(1) & (a)(2) analysis, the district court reasoned that the partnership agreement provided that 70% of the limited partner interests could remove the general partner, so the decedent's 99% limited partnership interest allowed the decedent to remove the general partner and appoint herself or someone of her choosing as the new general partner, who in turn had the sole discretion to decide on distributions of income from the partnership. Therefore, the decedent "retained the power to either personally benefit from the income of the partnership or to designate the persons who would benefit from the income of the partnership, and thus runs afoul of both § 2036(a)(1) and § (2)." The taxpayer argued that *Byrum*'s fiduciary duty analysis should forestall the application of §2036, but the district court observed that the partnership agreement stated that the general partner did not owe a fiduciary duty to the partnership or other partners, and in any event the decedent could remove the general partner and appoint herself as general partner and "would not owe a fiduciary duty to the other Partners who, in any case, own only a miniscule share of the Partnership. Assuming such fiduciary duties exist, to whom does a party which owns 99% of the Partnership owe them?"

The Fifth Circuit reversed the district court's decision that "(1) family members cannot enter into a bona fide transaction, and (2) a transfer of assets in return for a pro rata partnership interest is not a transfer for full and adequate consideration." Because the bona fide sale for full and adequate exception applied for transfers to the partnership, the court did not need to address whether the decedent retained an interest to which §2036(a)(1) or (a)(2) would apply for transfers to the partnership.

In analyzing transfers to the LLC, however, the Fifth Circuit did not address whether the bona fide sale for full and adequate consideration exception applies to transfers. Instead, the court held that even if the exception does not apply, the decedent did not retain sufficient control of the assets transferred to the LLC to make her transfer subject to §2036(a), because she was only held a 50% interest in the LLC and her son had sole management powers over the LLC.

> Mrs. Kimbell's interest in the LLC was only a 50% interest, and her son had sole management powers over the LLC. Thus, Mrs. Kimbell did not retain the right to enjoy or designate who would enjoy the LLC property.

There was no specific discussion of the LLC transfers in the district court opinion. If the Fifth Circuit was suggesting that a pure control test should be used to gauge whether a decedent has retained a right to designate who can possess or enjoy property, that approach is suspect, because the *Byrum* decision rejected a "control" standard in applying §2036(a)(2):

> The 'control' rationale, urged by the Government and adopted by the dissenting opinion, would create a standard—not specified in the statute—so vague and amorphous as to be impossible of ascertainment in many instances. 408 U.S. 125, no.10 (1972).

A strict control test makes no sense, because many courts have blessed transfers to trusts, with the grantor as trustee with complete control over trust distributions, as long as distributions may be made only under a determinable standard. Perhaps the Fifth Circuit was just saying that the decedent had no ability at all to designate who could possess or enjoy property where she was only a 50% member and not the sole manager. Therefore, there was no need to address whether any power at all to designate would rise to the level of a "right to designate," taking into consideration any fiduciary or other limitations on the exercise of that power.

The Fifth Circuit's analysis of §2036(a)(2) is inconsistent with an extremely broad application of the "in conjunction with" language in §2036(a)(2) suggested in *Strangi*. Judge Cohen's *Strangi* analysis, if pushed to its limits, would suggest that retaining even a 1% limited partnership interest could risk inclusion of the entire partnership contribution because that 1% limited partner, in conjunction with all other partners, could dissolve and liquidate the partnership at any time. The *Kimbell* decision would not agree with that theory, indicating that even a 50% member interest in an LLC, where the decedent was not the sole manager, would not cause inclusion under §2036(a)(2).

The Fifth Circuit stayed the appeal of *Strangi* pending the resolution of *Kimbell.* Following the Fifth Circuit's decision in *Kimbell*, the Fifth Circuit subsequently affirmed *Strangi* based on §2036(a)(1)¸ without any discussion of the §2036(a)(2) analysis.

e. ***Estate of Mirowski v. Commissioner***. *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74 addressed whether §2036 applied to original transfers to an LLC and whether §§2036 or 2038 applied to 48% gifts of LLC interests. The decedent was the sole general manager of the LLC. As to the original transfers to fund the LLC, the court determined that the bona fide sale for full consideration applied. As to the assets attributable to the 48% gifts of LLC interests, the full consideration exception obviously did not apply.

The IRS argued under §2036(a)(2) that the decedent kept the right to designate who could possess or enjoy the transferred property or the income therefrom as to the 48% interests that were given to the daughters' trusts. The IRS pointed to the decedent's right to dispose of assets in the ordinary course of business (with the approval of the daughters), and the decedent's power as majority member owner to determine the timing of the distribution of capital transaction proceeds. The IRS also argued that the LLC assets should be included in the decedent's estate under §2038.

[Observation: The IRS did not argue that merely being the sole general manager of an LLC results in keeping proscribed powers under §2036(a)(2) or §2038.]

The court said that it rejected that argument for the same reasons it gave for the similar argument as to the express retention of a §2036(a)(1) right under the same general reasoning. Similarly, the court rejected the government's argument under §2038 that the decedent had the power acting alone or in conjunction with another person to alter, amend, revoke, or terminate the transfer. The IRS gave the same reasons as under its §2036(a)(2) argument, and the court summarily rejected the arguments for the same reasons as under the §2036(a)(2) analysis.

The reasoning under the court's §2036(a)(1) analysis that it relied on to reject the application of §§2036(a)(2) and 2038 that the court relied on included that the decedent was the general manager, and the general manager had sole authority to manage the LLC affairs, including the authority to determine the timing and amounts of distributions. The LLC operating agreement said that except as otherwise provided, "the timing and the amount of all distributions shall be determined by the Members holding a majority of the Percentages then outstanding." The court responded that the general manager has a fiduciary duty under state law. Also, other provisions of the operating agreement required pro rata allocations of profit and loss and pro rata distribution of capital proceeds from capital transactions. Furthermore, the authority to determine the timing and amounts of all distributions was a power given to the majority members, not the general partner. Even as to the decedent's authority as the majority holder of the member interests, the section referring to determining the timing and amounts of distributions is subject to other provisions of the operating agreement, including pro rata distribution of "cash flow," pro rata allocation of profit and loss, and pro rata distribution of capital proceeds from capital transactions.

f. ***Estate of Turner v. Commissioner***. *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209) followed *Strangi* in applying §2036(a)(2) in a broad manner to the decedent's interest as general partner (in addition to holding that the FLP assets would be included under §2036(a)(1)). (As in *Strangi*, the §2036(a)(2) discussion may technically be dictum in that the court had already decided that the assets would be included in the gross estate under §2036(a)(1). *Powell'*s application of §2036(a)(2) clearly is not dicta; the court declined to consider §§2036(a)(1) and 2038 because it had held that §2036(a)(2) applied.)

In *Turner,* the decedent and his wife transferred marketable securities and investment assets to a family limited partnership in return for the 1% general partnership interest and 99% limited partnership interests (owned equally by them). They retained assets, the income from which was sufficient to provide their living expenses (but some partnership assets were used for the benefit of the decedent and his wife). In late 2002 and early 2003, the decedent and his wife made gifts of 43.6% limited partnership interests to family members.

The court (Judge Marvel) concluded that that one-half of the partnership assets (representing the decedent's one-half of the assets contributed to the partnership) were included in the decedent's estate under §2036(a)(1) and also under §2036(a)(2). The bona fide sale exception to §2036 did not apply.
The court rejected the purported nontax reasons urged by the estate: asset consolidation and centralized management, resolving family disputes, and asset protection for one grandchild.

The *Turner* court acknowledged that a transferor's retention of the right to manage transferred assets does not necessarily require inclusion under §2036(a)(2), citing *Byrum* and *Schutt v. Commissioner.* However, the court gave no further analysis whatsoever of limits imposed by *Byrum,* in particular.

One of the reasons given by the court for applying §2036(a)(2) was that the decedent effectively was the sole general partner. (In footnote 28, the court acknowledged that the decedent's wife was an equal co-general partner, but the court concluded that even if it were to treat her as a "coequal" general partner, it would reach the same conclusion because §2036 (a)(2) applies if the power is held "alone or in conjunction with any person.") This again raises the specter of applying the "in conjunction with" language broadly that was addressed in *Strangi.*

The court mentioned three powers that the general partner had, without giving any weight to how important each was in triggering §2036(a)(2). Those powers were:

- The sole and absolute discretion to make pro rata distributions of partnership income (in addition to distributions to pay federal and state tax liabilities);
- To make distributions in kind; and
- To amend the partnership agreement at any time without the consent of the limited partners. (Even if the consent of limited partners had been required to amend the agreement, the court observed that the decedent and his wife retained more than 50% of the limited partnership interests and could make any decision requiring a majority vote of limited partners.)

Perhaps the court was focusing on the general partner's unilateral power to amend the partnership agreement, which is not a typical provision in family limited partnership agreements. If that is the case, the court conclusion would not have broad application to family limited partnership planning.

g. **Section 2036(a)(2) Arguments Made in *Black v. Commissioner***. The IRS's brief in *Black v. Commissioner* [133 T.C. 340 (2009)] made the argument suggested in the lower court *Strangi* opinion that the decedent's power, "in conjunction with others" triggered §2036(a)(2). In *Black*, the decedent was the 1% general partner and his son was a 0.5% general partner. The decedent held 77% of the limited partner interests at his death. The brief argued that the FLP could be dissolved and liquidated on the approval of all partners, and the decedent, "in conjunction" with the other partners could have amended the partnership agreement or simply dissolved the partnership and accelerated the enjoyment of the partnership's assets. Furthermore, the IRS argued that the decedent, acting alone as the holder of a majority of limited partnership interests, retained the right to approve transactions not in the ordinary course of business.

> Each of these rights conferred by the BILP agreement constitutes the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the transferred assets or the income therefrom during the decedent's lifetime for purposes of §2036(a)(2)…. And none of these rights were circumscribed by any meaningful fiduciary duty [citing a provision in the agreement that the managing partner will be indemnified for all claims except those based on gross negligence, fraud, deceit or wrongful taking]…. Stated another way, on these facts, the existence of limited fiduciary duties is not a meaningful constraint on the powers conferred under the BILP agreement. Opening Brief of Respondent at 112 (Feb. 22, 2008), *Estate of Black v. Commissioner*, 133 T.C. 340 (2009).

Black held that the bona fide sale for full consideration exception to §2036 applied, so it did not address the government's §2036(a)(2) argument.

20. **Summary of §2036 FLP/LLC Cases (14-22, With 2 on Both Sides)**. Of the various FLP cases that the IRS has chosen to litigate, fourteen have held that at least most of the transfers to an FLP qualified for the bona fide sale exception —

(1) *Church v. United States,* 2000-1 USTC ¶60,369 (W.D. Tex. 2000) (preserve family ranching enterprise, consolidate undivided ranch interests);

(2) *Estate of Eugene Stone v. Commissioner*, T.C. Memo 2003-309 (partnerships to settle family hostilities);

(3) *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004), *vacating and rem'g* 244 F. Supp. 2d 700 (N.D. Tex. 2003) ("substantial business and other nontax reasons" including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests);

(4) *Bongard v. Commissioner*, 124 T.C. 95 (2005) (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts);

(5) *Estate of Schutt v. Commissioner*, T.C. Memo 2005-126 (maintaining buy and hold investment philosophy for family du Pont stock);

(6) *Estate of Mirowski v. Commissioner*, T.C. Memo 2008-74 (joint management and keeping a single pool of assets for investment opportunities);

(7) *Estate of Miller v. Commissioner*, T.C. Memo 2009-119 (continue investment philosophy and special stock charting methodology);

(8) *Keller v. United States*, 2009-2 USTC ¶60,579 (S.D. Tex. 2009) (protect family assets from depletion in divorces);

(9) *Estate of Murphy v. United States*, No. 07-CV-1013, 2009 BL 223971 (W.D. Ark. Oct. 2, 2009) (centralized management and prevent dissipation of family "legacy assets"),

(10) *Estate of Black v. Commissioner*, 133 T.C. 340 (2009) (maintaining buy and hold investment philosophy for closely held stock),

(11) *Estate of Shurtz v. Commissioner*, T.C. Memo 2010-21 (asset protection and management of timberland following gifts of undivided interests),

(12) *Estate of Joanne Stone v. Commissioner*, T.C. Memo 2012-48 (desire to have woodland parcels held and managed as a family asset and various other factors mentioned),

(13) *Estate of Kelly v. Commissioner*, T.C. Memo 2012-73 (ensuring equal estate distribution, avoiding potential litigation, and achieving effective asset management), and

(14) *Estate of Purdue v. Commissioner*, T.C. Memo 2015-249 (centralized management and other factors).

Three cases (*Kelly*, *Mirowski*, and *Kimbell*) held that §2036 did not apply (at least as to some assets) without relying on the bona fide sale for full consideration exception. *All* of the FLP cases resulting in taxpayer successes against a §2036 attack have relied on the bona fide sale exception to §2036 except these three cases, *Kelly* relied on the bona fide sale exception to avoid treating the contributions to partnerships as transfers triggering §2036, but reasoned that there was no retained enjoyment under §2036(a)(1) as to gifts of limited partnership interests [that obviously did not qualify for the bona fide sale for full consideration exception]. *Mirowski* similarly relied on the bona fide sale exception with respect to contributions to the partnership, but not as to gifts of partnership interests. *Kimbell* relied on the bona fide sale for full consideration exception as to transfers to a partnership, but as to other transfers to an LLC, the Fifth Circuit refused to apply §2036 (the particular issue was about §2036(a)(2)) without addressing whether the bona fide sale for full consideration exception applied to those transfers.

Interestingly, six of those fourteen cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the *Miller*, *Joanne Stone*, and *Purdue* cases and authored the Tax Court's opinion in *Bongard*. Judge Chiechi decided both *Stone* and *Mirowski*. (Judge Wherry decided *Schutt*, Judge Halpern decided *Black*, Judge Jacobs decided *Shurtz*, Judge Foley decided *Kelly*, and *Church* and *Kimbell* were federal district court opinions ultimately resolved by the 5th Circuit. *Keller* and *Murphy* are federal district court cases.)

Including the partial inclusion of FLP assets in *Miller* and *Bongard*, 22 cases have applied §2036 to FLP or LLC situations: *Estate of Schauerhamer v. Commissioner*, T.C. Memo 1997-242, *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000), *Estate of Harper v. Commissioner*, T.C. Memo 2002-121, *Thompson v. Commissioner*, T.C. Memo 2002-246, *aff'd*, 382 F.3d 367 (3d Cir. 2004), *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-15, *aff'd,* 417 F.3d 468 (5th Cir. 2005)*, Estate of Abraham v. Commissioner*, T.C. Memo 2004-39, *Estate of Hillgren v. Commissioner*, T.C. Memo 2004-46, Estate of *Bongard v. Commissioner*, 124 T.C. 95 (2005) (as to an LLC but not as to a separate FLP), *Estate of Bigelow v. Commissioner*, T.C. Memo 2005-65, *aff'd*, 503 F.3d 955 (9th Cir. 2007), *Estate of Edna Korby v. Commissioner*, T.C. Memo 2005-102, *aff'd*, 471 F.3d 848 (8th Cir. 2006), *Estate of Austin Korby v. Commissioner*, T.C. Memo 2005-103, *aff'd*, 471 F.3d 848 (8th Cir. 2006), *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115, *Estate of Erickson v. Commissioner*, T.C. Memo 2007-107, *Estate of Gore v. Commissioner*, T.C. Memo 2007-169, *Estate* *of Rector v. Commissioner*, T.C. Memo 2007-367, *Estate of Hurford v. Commissioner*, T.C. Memo 2008-278, *Estate of Jorgensen v. Commissioner*, T.C. Memo 2009-66, *aff'd*, 431 Fed. Appx. 544 (9th Cir. 2011), *Estate of Miller v. Commissioner*, T.C. Memo 2009-119 (as to transfers made 13 days before death but not as to prior transfers), *Estate of Malkin v. Commissioner*, T.C. Memo 2009-212, *Estate of Holliday v. Commissioner*, T.C. Memo 2016-51, *Estate of Beyer v. Commissioner*, T.C. Memo 2016-183, and *Estate of Powell v. Commissioner,* 148 T.C. No. 18 (2017). In addition, the district court applied §2036 in *Kimbell v. United States* but the 5th Circuit reversed.

16. Portability

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

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

- The portability election is made by the executor's filing a timely and complete Form 706 (if the estate tax return is not timely filed and if the estate is small enough that no return would otherwise be required, Rev. Proc. 2014-18 allowed a relief procedure for certain estates through December 31, 2014, and 9100 relief is available otherwise as long as the estate was not required to file an estate tax return, Reg. §20.2010-2(a)(1); one of the requirements for 9100 relief is that the taxpayer sought professional advice, but the rulings often do not mention that fact so the IRS is apparently being lenient with respect to that requirement in this context);
- In most cases no need to list values of assets passing to a surviving spouse or charity on the "timely and complete" Form 706 exists if the estate was not otherwise required to file an estate tax return (but the return must include an estimate of the total value of the gross estate within specified ranges, including assets passing to a spouse or charity);
- The surviving spouse's DSUE amount is not subject to being reduced if Congress later reduces the basic exclusion amount;
- The regulations adopt the "Example 3" approach of the Joint Committee Technical Explanation, negating any "privity" requirement in calculating the DSUE amount (an approach adopted legislatively by ATRA);

- If the decedent made gifts requiring the payment of gift tax, the excess taxable gift over the gift exemption amount (on which gift tax was paid) is not considered in calculating the DSUE amount;
- The surviving spouse can use the DSUE amount any time after the decedent's death, assuming the portability election is eventually made by the executor;
- Any gifts made by the surviving spouse are first covered by the DSUE amount, leaving the spouse's own exclusion amount to cover later transfers;
- DSUE amounts from multiple spouses may be used to the extent that gifts are made to utilize the DSUE amount from a particular spouse before the next spouse dies; and
- If the estate leaves assets to a QDOT, the surviving spouse cannot use the DSUE amount until the QDOT is fully distributed (or terminates at the surviving spouse's death).

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

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

b. **Using QTIP Trust Planning With Portability, Rev. Proc. 2016-49, Modifying and Superseding Rev. Proc. 2001-38**. The IRS on September 27, 2016 released Rev. Proc. 2016-49 to modify and supersede Rev. Proc. 2001-38 and clarify that portability can be used in connection with QTIP trusts. Rev. Proc. 2001-38 gave estates the option of electing to treat an unneeded QTIP election (if the QTIP election was not needed at all to reduce the estate tax to zero) as null and void. Some planners were concerned that the IRS might nullify QTIP elections when they were not needed to reduce the estate tax to zero, thus leaving less unused exclusion (DSUE amount) if the portability election were made, and keeping the trust assets from being included in the surviving spouse's estate to achieve a basis adjustment at the surviving spouse's subsequent death. *See e.g.*, Rodney L Goodwin, *IRS Rules No Date-of-Death Basis on Death of Surviving Spouse–PLR Finds QTIP Election Null and Void* , TRUSTS & ESTATES (June 20, 2016) (discussing PLRs 201615004 & 201603004).

The preamble to the portability final regulations (T.D. 9725) stated that the IRS intended to provide guidance to "clarify whether a QTIP election made under section 2056(b)(7) may be disregarded and treated as null and void when an executor has elected portability of the DSUE amount under section 2010(c)(5)(A)." The 2014-2015, 2015-2016, and 2016-2017 Priority Guidance Plans have included this project. Planners have speculated why the guidance has taken such a long time to complete. Perhaps the IRS was concerned with avoiding potential abuses such as: (i) nullifying a QTIP election after DSUE amount had been used to shelter gifts by the surviving spouse; (ii) nullifying a QTIP election if the surviving spouse remarried, thus losing the first spouse's unused DSUE amount; or (iii) nullifying the QTIP election if the QTIP assets decline in value by the time of the surviving spouse's death to avoid a step-DOWN in basis under §1014.

Purpose. Rev. Proc. 2016-49 explains that the purpose of Rev. Proc. 2001-38 was to provide relief to estates that inadvertently made the QTIP election at the first spouse's death when the election was not needed to reduce the estate tax. The surviving spouse's estate could nullify the QTIP election so that the assets in the QTIP trust would not be included in the surviving spouse's gross estate. The new revenue procedure explains that with the amendment to the Code allowing portability elections, a deceased spouse's estate may wish to elect QTIP treatment for property even when not necessary to reduce the estate tax lability, in order to leave a greater DSUE amount that could be utilized by the surviving spouse.

Operation of Rev. Proc. 2016-49. The new procedure requires an affirmative election by the taxpayer seeking to nullify the QTIP election and generally treats a QTIP election as void only if (i) the federal estate tax was zero regardless of the QTIP election, (ii) no portability election was made, and (iii) the taxpayer follows specified procedural requirements to treat the QTIP election as void.

The procedural requirements include: (i) filing a supplemental Form 706 (if the period of limitations has not expired), a Form 709 by the surviving spouse, or a Form 706 by the surviving spouse that has a notation at the top of the Form stating "Filed pursuant to Revenue Procedure 2016-49"; (ii) identifying the QTIP election that should be treated as void and explaining why the QTIP election was not needed to reduce the estate tax (because the taxable estate was less than the decedent's applicable exclusion amount) and that the portability election was not made (for example, because of an affirmative statement attached to the prior return declining to make the portability election or because the return was not timely filed); and attaching sufficient evidence to establish those facts (which could, for example, include a copy of the predeceased spouse's estate tax return or an account transcript reflecting that the estate tax return was filed late).

The revised procedure, allowing nullification of the QTIP election only if the portability election was not made on the predeceased spouse's return, avoids (or at least minimizes) potential abuse situations. (This is the approach recommended by the American Bar Association Real Property, Trust & Estate Law Section in comments filed with the IRS on June 11, 2013.)

This issue is important for portability planning. Being able to use QTIP trust planning creates flexibility by being able to decide after the first spouse dies whether to make a full QTIP election (and rely on portability to save estate taxes at the second spouse's death) or whether not to make the QTIP election and allow the assets in the QTIP trust to pass into a credit shelter trust.

The new procedure allows taxpayers to take steps, in appropriate situations, to nullify QTIP elections without having to incur the significant expense of obtaining a private letter ruling, which was required under Rev. Proc. 2001-38.

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

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

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

Making these decisions can be postponed until the first spouse's death when drafting documents for a couple by using a single QTIP approach or by building in ways to use disclaimers at the firs spouse's death. See Item 3.h.(3) above.

For a more detailed discussion of the advantages and disadvantages of the credit shelter trust approach and the portability approach, as well as a detailed discussion of complexities and inequities that can arise in a blended family situation if a credit shelter trust is not used at the first spouse's death, see Item 13.d of the Current Developments and Hot Topics Summary (December 2016) found **here** and Item 5.d-f of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

d. **Relief Procedure for Extension of Time to File Returns to Elect Portability, Rev. Proc. 2017-34.** Section 2010(c)(5)(A) requires that the portability election be made on an estate tax return for the decedent whose unused exclusion amount is being made available to the surviving spouse. Rev. Proc. 2014-18 allowed a relief procedure for certain estates through December 31, 2014 and Rev. Proc. 2017-34 provides a relief procedure through the later of January 2, 2018 or the second anniversary of the decedent's date of death in certain cases if the estate was not otherwise required to file an estate tax return. This is a very helpful relief measure (which avoids the necessity of the taxpayer paying a hefty user fee for a ruling under §301.9100-3 to obtain an extension of the time for filing the return to make the portability election).

The Procedure states that a "considerable number of ruling requests for an extension of time to elect portability" have been filed, indicating "a need for continuing relief for the estates of decedents having no filing requirement"(which will also relieve "a significant burden" that the ruling requests have placed on the IRS). The two-year limitation on the relief is designed to prevent prejudice to the government from a lack of available records, and also generally avoids the possibility that the period for filing a claim for refund of gift or estate tax paid by the surviving spouse or the surviving spouse's estate would have expired before the portability election was made under this relief procedure.

Requirements for qualifying for the relief procedure are:

- the decedent (i) was survived by spouse, (ii) died after December 31, 2010, and (iii) was a citizen or resident of the United States;
- the executor was not required to file an estate tax return under §6018(a) based on the value of the gross estate and adjusted taxable gifts (without regard to the need to file for portability purposes);
- the executor did not file an estate tax return within the time required under §20.2010-2(a)(1);
- the election is made on a complete and properly prepared Form 706 that is filed on or before the later on January 2, 2018 or the second annual anniversary of the decedent's data death; and
- the following statement appears at the top of the Form 706 – "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)." (§§3.01 & 4.01.)

If a later determination is made that the executor was required to file an estate tax return (based on the value of the gross estate and adjusted taxable gifts), relief under this procedure is deemed null and void *ab initio*. (§4.03.)This relief procedure does not extend the period of limitations for filing a claim for refund with respect to an overpayment of tax (for example, if the surviving spouse paid a gift tax or died and paid an estate tax that could have been avoided with the applicable exclusion amount made available under the portability election). (§5.01.) However, a claim for refund filed in anticipation of a Form 706 being filed to elect portability pursuant to this Revenue Procedure will be considered a protective claim for refund (§5.02). (Accordingly, if a decedent died after 2010 but before about 2014, and if the surviving spouse paid a gift tax or estate tax for which the period of limitations on a refund will end before a "complete and properly prepared Form 706"

can be filed, the taxpayer should file a protective claim for refund before the end of the limitations period stating that it is in anticipation of a complete return being filed pursuant to this Revenue Procedure.

If an estate does not qualify for relief under this Revenue Procedure (i.e., it does not file a complete and properly prepared Form 706 by the later of January 2, 2018 or the second anniversary of the decedent's death), it may request relief under §301.9100-3. (§3.03.)

e. ***Estate of Vose,* Court Forces Executor to Make Portability Election Despite Marital Agreement Waiving All of Surviving Spouse's Rights to Decedent's Estate**. The Oklahoma Supreme Court affirmed the lower court's decision forcing the executor to file an estate tax return making the portability election, even though the surviving husband had signed a prenuptial agreement waiving "all claims and rights, actual, inchoate, vested, or contingent" in the estate. *In re Matter of the Estate of Anne S. Vose v. Lee*, __ P.3d __, 2017 WL 167587 (Okla. Jan. 17, 2017). (Observation: The family's pronunciation of "Vose" rhymes with "gross" not "doze.") This is a case of national first impression, addressing (i) whether a prenuptial agreement waiving "all claims and rights" to an estate waived any interest that the surviving spouse had in the DSEU amount if the portability election were made, and (ii) an executor's fiduciary duty to make the portability election where the spouse was not a beneficiary of the estate.

Regarding the prenuptial agreement issue, the court observed that a valid waiver requires "full knowledge of the rights intended to be waived," that §2010 (enacted after the agreement was signed) granted the husband "a potential interest in a part of Decedent's estate," and distinguished the waiver of all "claims and rights" in the estate by concluding that "[t]he portable DSUE is not simple property acquired by one party over the course of the marriage according to existing laws in effect when the agreement was made." This is a case of first impression regarding the reach of a pre-existing prenuptial agreement attempting to waive "all rights" in an estate, whether known or unknown, but that pre-dated the portability election and obviously did not mention portability. The case emphasizes the importance of specifically addressing the parties' intentions regarding portability in structuring prenuptial agreements. *See generally* George D. Karibjanian and Lester B. Law, *Portability and Prenuptials: A Plethora of Preventative, Progressive, and Precautionary Provisions,* BNA Estate, Gift and Trusts J., (March-April 2013).

The court emphasized that the personal representative had a fiduciary relationship to "all parties that have an interest in the estate," and that the surviving husband is the only person that has "an interest in and the ability to use the DSUE" amount. The personal representative argued that the estate should be able to demand consideration from the surviving husband, but the court focused on the fact that the DSUE would be lost if the election were not made and that the surviving husband agreed to pay any costs associated with filing the return to make the election.

The significance of this case of first impression is summarized:

> The Court determined that Personal Representative has a "fiduciary obligation to … safeguard [Surviving Spouse's] interest in the DSUE [amount]." This is novel! Even though the Court never stated that the DSUE amount is an estate asset, by imposing on Personal Representative the duty to safeguard the DSUE amount for Surviving Spouse, the Court treated it as such.
>
> **Monday Morning Quarterback Analysis of the Decision**
>
> After reviewing the Court's decision and "reading between the lines," we believe that the holding is based on the two important facts. First, there would be great loss to Surviving Spouse if the election were not made, and there would be absolutely no harm to the estate in

> making the election. Second, the Court applied the "we won't tolerate unreasonable personal representatives" rule.
>
> …
>
> This is a true case of national first impression. Since the early days of portability, we anticipated that a case similar to this would eventually surface, we did not necessarily anticipate this the result and/or the court's reasoning. We believe that the case left many unanswered questions, but yet gave some idea of how other state courts may view the issue. The best lesson learned from this case is that one should now, more than ever, be diligent about addressing the issue of making the portability election in the planning phase for the clients.

Lester Law & Howard Zaritsky, In re Matter of the Estate of Anne S. Vose v. Lee: *Court Forces the Portability Election – Is Pandora's Box Open?*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2513 (February 8, 2017).

f. **Planning Considerations.** 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** and available at **www.Bessemer.com/Advisor**.

g. **Forms.** The 2017 Heckerling materials regarding portability by Lester Law and Howard Zaritsky have outstanding forms for a wide variety of issues regarding portability planning including: basis adjustment planning flexibilities [power to grant a general power of appointment, formula general powers of appointment, and exercising a power of appointment to trigger the Delaware tax trap], marital agreement provisions regarding portability, and will provisions regarding directions for portability elections and payment of expenses.

17. State Income Taxation of Trusts

a. **Background.** All of the 43 states plus the District of Columbia that impose an income tax on trusts tax the undistributed income of a non-grantor trust as a "resident trust" based on one or more of the following five criteria: (1) if the trust was created by a resident testator (for a testamentary trust), (2) if the trust was created by a resident trustor (for an inter vivos trust), (3) if the trust is administered in the state, (4) if the trust has a resident fiduciary, and (5) if the trust has a resident beneficiary. Observe that the governing law of the trust is not one of those criteria (except in Louisiana; also in Idaho and North Dakota that is a factor considered along with other factors). A trust included in one of the first two categories is referred to as a "founder state trust" (i.e., the trust is a resident trust if the founder of the trust was a resident of the state).

See Item 20.d of the 2012 Heckerling Musings found **here** and available at **www.Bessemer.com/Advisor** for a summary of the court cases that have addressed the constitutionality of state tax systems that tax trusts based on the testator of a testamentary trust or settlor of an inter vivos trust residing in the state. Based on those cases, most commentators believe that taxing a nonresident trust solely because the testator or settlor was a resident is probably unconstitutional.

However, if that state's court system is utilized, for example, because of a probate proceeding in that state, chances are better that the state does have the authority to tax the trust.

For a very complete survey of the nexus rules in the various states, see the Bloomberg BNA Special Multistate Tax Report, 2017 Trust Nexus Survey, available at **http://src.bna.com/tBG** (published October 2017).

b. **Significance**. This issue is arising more frequently as (1) states are strapped for revenue and are getting more aggressive, and (2) beneficiaries and individual trustees are more mobile, which may have the effect of changing the tax situs. Beware of naming family members as trustee without considering whether the appointment could cause the trust to be subject to income tax in the state of the trustee's residence. These issues are exacerbated by the trend of splitting up trustee functions among co-trustees, increasing the possible likelihood of having at least one co-trustee in a state that uses the trustee's residence as a basis for taxing trusts.

c. **Recent Trend of Cases Rejecting Constitutionality of State Trust Taxation Approaches.** Recent cases have held or suggested that Illinois, New Jersey, North Carolina, and Pennsylvania could not tax trusts merely because the settlor was a resident of those states when the trust was created. *E.g., Linn v. Dep't of Revenue*, 2013 IL App (4th) 121055 (2013); *McNeil v. Commonwealth of Pennsylvania*, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011 (2013). For further discussion about the details of each of these cases (and other 2013 cases in North Carolina and New Jersey), see Item 22.a of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

Two of the earlier North Carolina and New Jersey lower court cases have been addressed further in 2015. In *Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 12 CVS 8740 (N.C. 2015), the lower court held on summary judgment that "the beneficiary's residence in North Carolina, standing alone, is not a sufficient contact by [a trust] with this State to support the imposition of the tax at issue," citing the Due Process Clause and the Commerce Clause of the U.S. Constitution. The North Carolina Court of Appeals affirmed, finding the state tax unconstitutional on the grounds that the minimum contacts criteria of the Due Process Clause were not satisfied, (N.C. Ct. App. July 5, 2016).

Residuary Trust A u/w/o Kassner v. Director, Division of Taxation, 2015 N.J. Tax LEXIS 11, 2015 WL 2458024 (N.J. Sup. Ct. App. 2015), *aff'g* 27 N.J. Tax 68 (N.J. Tax Ct. 2013) is the appellate case affirming the 2013 lower court opinion. The trust's only connection to New Jersey was that it was a shareholder of an S corporation that owned New Jersey assets. The trust paid tax on its portion of the flow through income from the S corporation's New Jersey assets but not on its other income. The court concluded that the announcement in the Division of Taxation's official publication that the trust income would not be taxed under certain circumstances and then changing that position retroactively was fundamentally unfair. The court did not address constitutional issues.

Minnesota is the latest state to join this trend. In *William Fielding, Trustee of the Reid and Ann MacDonald Irrevocable GST Trust for Maria V. MacDonald, et al., v.*

Commissioner of Revenue, (Minn. May 31, 2017), the court addressed the Minnesota statute providing that an inter vivos trust is treated as a resident trust if the grantor was a Minnesota resident when the trust became irrevocable. The taxpayer paid income tax on all income earned by the trust in 2014, but filed a claim for refund, alleging that Minnesota's taxation of non-Minnesota income merely on the basis of the grantor being domiciled in Minnesota when the trust became irrevocable was unconstitutional, violating the due process clauses of the Minnesota and U.S. constitutions, and the Commerce Clause of the U.S. Constitution. The Commissioner tried to point to other (rather minimal) contacts with Minnesota, but the court concluded that the only factor that was relevant for consideration was the statute's description of the grantor's domicile when the inter vivos trust became irrevocable and whether that basis was sufficient on constitutional grounds. The court concluded that the grantor-domicile sole basis under the Minnesota statute for treating an inter vivos trust as a Minnesota resident trust violated the due process provisions of the Minnesota and United States constitutions. Minnesota was not entitled to tax the income from the sale of stock (of a Minnesota corporation) or income from an out of state investment account.

d. **Supreme Court-Credits for State and County Taxes From Other States.** In *Comptroller of the Treasury of Maryland v. Wynne,* 135 S. Ct. 1787 (2015), Maryland residents had taxable income from an S corporation that was sourced in several other states. They paid taxes to those states and sought a credit for the taxes paid against their Maryland state and county income taxes. They received a credit against their state income tax, but not the county level tax. The Supreme Court affirmed the Maryland Court of Appeals finding that the failure to provide the credit at the county level unconstitutionally discriminated against interstate commerce. The failure to provide the credit violates the dormant Commerce Clause by burdening out-of-state business with double taxation.

e. **Corporate Trustee Treated as "Inhabitant" of State**. Massachusetts taxes inter vivos trusts created by residents of the state if a trustee or beneficiary is a resident of the state. In *Bank of America, N.A. v. Massachusetts Commissioner of Revenue,* C314596-8; 314606-36 (Mass. Appellate Tax Board. June 10, 2015), 2016 Mass. LEXIS (July 11, 2016), the Massachusetts Supreme Judicial Court concluded that a national bank with offices in Massachusetts was determined be an "inhabitant" of Massachusetts and was therefore a resident trustee.

f. **Annual Review of Trust Status.** Trustees should inquire annually whether co-trustees or beneficiaries have moved to a new state. If so, the trustee should determine whether the new state taxes trusts based on the residency of a trustee or beneficiary, whether that system is constitutional, and if not, make decisions how to proceed.

18. Tax Effects of Settlements and Modifications

The tax effects of court modifications, other trust modifications, decanting, and settlements are summarized in Items 42-51 of the ACTEC 2015 Annual Meeting Musings summary found **here** and available at **www.Bessemer.com/Advisor**. This Item includes several brief miscellaneous comments.

a. **Significance**. Settlements and trust modifications can have tax effects. Litigators nearing the end of long mediations or settlement discussions often will just make an off-hand comment that "we agree there are no tax issues." One or more of the parties later will be most unhappy when advised of the tax effects (and, indeed, may make attempts to set aside the settlement agreement).

b. **Court Judgments—*Bosch***. *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967) addresses the respect that federal courts must give to state court proceedings in tax cases. A trustee brought a construction suit requesting whether the wife's release of the general power of appointment was effective under state law. The trial court ruled that the release was a nullity. The Tax Court and Second Circuit Court of Appeals allowed a marital deduction for assets passing from the trust at the husband's death because the surviving wife had a general power of appointment. The Supreme Court observed that legislative history regarding the marital deduction directed that "proper regard" be given to state court construction of wills. Because the Senate stated "proper regard" rather than "final effect," the opinion concluded that state court decisions should not be binding on the issue, and that federal courts in tax cases will be bound only by the state's highest court in the matter before it.

c. **Settlements—*Ahmanson***. The *Bosch* approach is applied to settlements in *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981). A four-part test is used to determine if the results of a settlement will govern the tax consequences. (1) *Dispute* – the case arose from a bona fide dispute. (2) *Bona Fide Claim* – the amount received by the parties should be something that is premised on a bona fide claim under state law. (3) *Quantitative Test* – the recipient does not receive more property than could be covered if the person received a full recovery following a trial. (4) *Qualitative* Test – amounts received must be of a character and nature of what the person was entitled to under state property rights. (For example, if a residual beneficiary settles for a fixed sum of money, it cannot take a position that it received a specific bequest that does not carry out DNI.)

   If the IRS concludes that a bona fide controversy does not exist, it can either treat the exchange of property as a gift or as a sale for full consideration, depending on the situation.

   Effectively, the IRS seems to be taking the position that a "settlement tax" exists. The IRS is more inclined to give consideration to a court judgment, but totally ignore settlements because they are viewed as collusive transfers. The courts and national office of the IRS typically realize that the four-part analysis applies, but individual examiners are extremely suspicious of collusion in settlements.

d. **Revenue Ruling 73-142—Pre-Transaction Actions Can Avoid *Bosch* Analysis**. In Rev. Rul. 73-142, a Settlor reserved the power to remove and replace the trustee with no express limitation on appointing himself, and the trustee held tax sensitive powers that would cause estate inclusion under §§2036 or 2038 if held by the grantor *at his death*. The Settlor obtained a local court construction that the Settlor only had the power to remove the trustee once and did not have the power to appoint himself as trustee. After obtaining this ruling, the Settlor removed the trustee and appointed another, so the Settlor no longer had the removal power. In Revenue Ruling 73-142, the state court determination, which was binding on everyone in the world after the appropriate appeals periods ran, occurred *before the* *taxing event*, which would have been the Settlor's death. The IRS agreed that it was bound by the court's ruling as well:

> In this case the lower court had jurisdiction over the parties and over the subject matter of the proceeding. Thus, the time for appeal having elapsed, its judgment is final and conclusive as to those parties, *regardless of how erroneous the court's application of the state law may have been.* Consequently, after the time for appeal had expired, the grantor-decedent did not have the power to appoint himself as successor trustee. The aforesaid rights and powers which would otherwise have brought the value of the trust corpus within the provisions of sections 2036 and 2038 of the Code were thus effectively cut off before his death.
>
> Unlike the situation in *Bosch,* the decree in this case was handed down *before the time of the event giving rise to the tax* (that is, the date of the grantor's death). Thus, while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such *date since the decree, in and of itself, effectively extinguished the power.* In other words, while there may have been a question whether the grantor had such power prior to the decree, there is no question that he did not have the power thereafter. Rev. Rul. 73-142, 1973-1 C.B. 405 (emphasis added).

Get the construction proceeding final order before the taxing event, and the IRS will be bound under Revenue Ruling 73-142. But the prior court order must be obtained *prior to* the event that would otherwise have been a taxable event.

PLRs 201723002 and 201723003 are examples of situations in which this opportunity should apply. The taxpayer reformed his irrevocable trust in a state court action to remove powers that were reserved to the grantor as a result of a scrivener's error, and the reformation was completed before the taxpayer died, which avoided estate inclusion under §§2035,2036, or 2038. The rulings reasoned that the reformation to correct the scrivener's error was consistent with state law under the *Bosch* doctrine, but the result should have been the same even without the *Bosch* analysis.

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

A reformation modifies a document, and the IRS position is that the reformation applies prospectively only. Accordingly, a post-death reformation may not result in an action causing assets to have passed to a surviving spouse or charity as of the date of death to qualify for an estate tax marital or charitable deduction.

Planners may be creative in finding an ambiguity that can be used in a construction proceeding, rather than using a reformation/modification proceeding, in light of the more favorable tax treatment resulting from construction actions. In *Hubble Trust v. Commissioner*, T.C. Summ. Op. 2016-67, a trust instrument gave the trustee the authority to use and distribute "[a]ll unused income and remainder of the principal … as will make such uses and distributions exempt from Ohio inheritance and Federal estate taxes and for no other purpose." The local court entered an order that the trust was ambiguous and that it authorized the trustees to make charitable distributions. The Tax Court agreed with the IRS that no latent ambiguity existed that could be construed by the probate court (even though the drafting attorney believed that the trustees were supposed to be authorized to make charitable distributions), and that distributions did not qualify for an income tax charitable deduction.

f. **Recent Rulings Regarding Tax Effects of Court Modifications**. A 2016 Chief Counsel Advice refused to give effect to a court modification for purposes of whether or not charitable distributions were made "pursuant to the terms of the governing instrument." CCA 201651013. The trust was modified to give the beneficiary a limited power of appointment in favor of charity. The IRS concluded that if the beneficiary exercised a power of appointment to make distributions to charity, a charitable deduction would not be available under §642(c) because the distribution would not be made pursuant to the terms of the governing instrument. A recent Chief Counsel Advice similarly concluded that assets appointed to charities under a power of appointment granted in a court modification would not satisfy the "pursuant to the terms of the governing instrument" requirement. CCA 201747005 (includes extended discussion of Bosch and Rev. Rul. 73-142). This conclusion seems incorrect; if the governing instrument is effectively modified under state law before the transfer to charity, subsequent transfers would seem to be made pursuant to the terms of the governing instrument in the absence of guidance under §642(c) that it looks only to the governing instrument as drafted, without valid modifications.

Various private letter rulings have concluded that a court ordered division of a "pot" trust into separate trusts for the beneficiaries would not have adverse GST, income, estate or gift tax consequences. PLRs 201702005 & 201702006 are good examples of rulings that have analyzed these issues with respect to court modifications. (Other PLRs holding that the division of a trust into separate trusts for the beneficiaries did not have gift tax consequences are PLRs 200419001, 2013409002, 201245007, 201243006, 201238004, 201218003, and 201205001. Similar rulings regarding the gift tax treatment of mergers of trusts are PLRs 201025026, 201024044, 201024017-201024024.)

A GRAT that left out some technical requirements was modified in a judicial action to satisfy the requirements in PLR 201652002. The IRS concluded that the modification corrected a scrivener's error, observing that the trust instrument provided that the grantor's retained interest was intended to constitute a qualified interest within the meaning of §2702(b)(1).

The judicial modification of grantor trusts to give the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trusts was ruled to be consistent with Rev. Rul. 2004-64, and did not result in a deemed transfer of property to the trust or other adverse gift tax or estate tax consequences. PLR 201647001.

g. **Gift Effects**. Because settlements by their nature involve compromise, an ever-present concern is whether any of the parties to the agreement have made a taxable gift. 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 or court modification/construction contexts. *E.g.*, PLRs 201342001, 201223012, 201220030, 201216010, 201210002, 201147010, 201104001, 200845028, 200825007, 200638020, 200631008, 200615006, and 200209008.

h. ***Redstone* Cases.** A settlement of litigation resolved a dispute regarding the ownership of 100 shares of closely-held stock registered in the name of Edward Redstone. The settlement resulted in the company agreeing to pay $5 million for 66 2/3 shares to Edward, with the remaining 33 1/3 shares being held in a trust for his children. The dispute centered around disagreements between Edward and his father, who was the president of the company, and who insisted that a portion of the shares were held in an "oral trust" for the benefit of the shareholder's children. The court concluded that the settlement constituted a bona fide, arm's length transaction that was free from donative intent and that was "made in the ordinary course of business." The transfer was made "for a full and adequate consideration in money or money's worth," which was the recognition that Edward was the outright owner of 66 2/3 of the shares in the agreement and that the company would pay $5 million in exchange for the shares. (The fact that Edward's children were not parties to the settlement agreement - and therefore provided no consideration for the transfer of the shares - did not matter for purposes of determining whether Edward received full consideration in the settlement.) *Estate of Edward Redstone v. Commissioner*, 145 T.C. 259 (2015) (Judge Lauber).

Edward's brother, Sumner Redstone, similarly had 100 shares of the company registered in his name. Three weeks after the settlement between Edward and the company was signed (and two days after the parties filed a stipulation with the court and the court issued a final decree incorporating the terms of the settlement agreement), Sumner engaged in similar transactions—agreeing to be paid $5 million for 66 2/3 shares and transferring his remaining 33 1/3 shares to irrevocable trusts for his children. Sumner said that he did this as a "gesture of goodwill to his father, who desired to ensure the financial security of his four grandchildren on equal terms," but Sumner was not required to take these actions under the settlement agreement between Edward and the company. The Tax Court (the same judge that wrote the opinion for the *Edward Redstone* case) concluded that Sumner's transfer of shares to the trusts for his children constituted taxable gifts, reasoning that pleasing parents is presumptively a family motivation. The court concluded: "There was no claim against Sumner; there were no arm's length negotiations; and he received no consideration from anyone in exchange for his transfer." *Sumner Redstone v. Commissioner,* T.C. Memo. 2015-237 (2015) (Judge Lauber).

In the *Edward Redstone* case, the court provided a planning roadmap in summarizing factors that the courts have considered to determine the tax consequences in a litigation settlement context:

> whether a genuine controversy existed between the parties; whether the parties were represented by and acted upon the advice of counsel; whether the parties engaged in adversarial negotiations; whether the value of the property involved was substantial; whether the settlement was motivated by the parties' desire to avoid the uncertainty and expense of litigation; and whether the settlement was finalized under judicial supervision and incorporated in a judicial decree. 145 T.C. at 271.

i. **Correcting Failure to Fund Trusts**. The manner in which a claim is couched can impact the tax effects of the modification. For example, if a surviving spouse fails to take steps to fund a bypass trust prior to his or her death, alternative arguments are a (i) debt approach (a claim for damages against the decedent), (ii) a constructive trust approach, (iii) a "vested" approach (*see Estate of Richard v. Commissioner*, T.C. Memo 2012-173 (2012)), or (iv) a "by their fruits" approach (*Estate of Olson v. Commissioner*, T.C. Memo 2014-58 (2014)). Under the debt approach, all of the assets would be in the surviving spouse's gross estate and a basis adjustment would be permitted at her subsequent death.

19. Social Security – Rules of Thumb About Age to Claim Benefits

a. ***Full Retirement Age***. The full retirement age is 65 for those born in 1937 or earlier, increasing in stages from age 65 to 66 for those born in 1938-1942, age 66 for those born in 1943-1954, and increasing in stages from age 66 to age 67 for those born in 1955-1959, and age 67 for those born in 1960 and later.

b. ***Collecting Early***. Retirement benefits can be started as early as age 62, but a permanent reduction in benefits will apply. For example, the percentage of benefits for a worker collecting early whose full retirement age is 66 is as follows: age 62-75%, age 63-80%, age 64-87%, age 65-93%, age 66-100%.

   The break-even age for a single person waiting until age 66 (versus age 62) and taking full benefits is age 78. The chance of a 62-year old male living beyond age 78 is 78% and for a 62 year old female the chance is 85%. Waiting until age 66 is a no brainer for most people, unless they cannot obtain work (and are desperate for cash flow for basic support) or have serious health issues AND are single.

c. ***Deferring Starting Benefits Beyond Full Retirement Age***. If benefits do not begin before or at the full retirement age, the annual benefits will permanently be increased, as follows: age 66-100%, age 67-108%, age 67-116%, age 69-124%, age 70 (or later, but there is no reason to defer to a later age)-132%. These are called "delayed retirement credits."

   At age 70, the maximum benefit is reached. If a worker defers receiving benefits, the benefits go up 8% per year, so from age 66 to age 70, the benefit would increase by 32% to about $43,000 per year.

d. ***Impact of Continuing to Work After Receiving Benefits***. If the worker begins receiving benefits before the full retirement age, the worker can earn up to $15,720/year in 2016 without any reduction in benefits. Earnings above that will reduce the benefits by $1 for every $2 earned above that limit.

   In the year when the full retirement age is reached (but before actually reaching full retirement age), the worker can earn up to $41,880/year without any reduction in benefits. Earnings above that will reduce the benefits by $1 for every $3 earned above that limit. Only earnings before the month the worker reaches full retirement age are counted for this purpose.

   Starting with the month the worker reaches full retirement age, there is no reduction for earnings.

e. ***Retirement Benefit Amounts***. The maximum retirement benefits in 2016 at full retirement age (66) for a person who always earned the maximum in the Social Security system for 35 years are as follows depending on when the benefits begin: age 62 – $2,102 per month; age 66 – $2,639 per month; and age 70 – $3,576. COLA adjustments apply and the amount may change in future years. These monthly amounts translate to annual amounts of $25,224, $31,668, and $42,912.

f. ***Deciding When to Apply for Benefits***. Factors in the decision of when to begin receiving benefits include the person's health status and life expectancy (e.g., if the person will die at age 64, it would be better to begin receiving benefits at age 62), the need for income, whether the worker plans to work, and the needs of survivors.

The COLA adjustments are made based on the initial base level of payments, so the COLA adjustments magnify the impact of the reduction for early payments. Taking early payments also impacts the level of survivor benefits following the worker's death. Another advantage of delaying payments is that the benefits are based on the 35 top years; dropping out 4 years or more from the late 1970s (when the earnings limit was *much* smaller) and adding the 4 most recent years of earnings results in a higher benefit level.

The most popular age for beginning benefits is age 62 (though that is not the wisest choice, and that percentage is declining). The next most popular age is 66. As suggested in paragraph b above, waiting until age 66 is best for most people.

In making the decision to delay receiving benefits from age 66 to age 70, observe that it takes about 12½ years to recover the four lost years of benefits–14 years taking into account the time value of money. Therefore, the decision to defer benefits means that the worker thinks he or she will live to age 82.5 (or age 84 taking into account the time value of money). Another factor to consider is that if the worker is likely to continue working until age 70, the individual will have a higher base for computing benefits as his or her 35 highest years, thus increasing the "principal insurance amount" even before the "delayed retirement credits" are applied.

The decision of when to apply for benefits also involves other issues, such as spousal benefits. Commercial resources that can assist in maximizing Social Security benefits include reasonably priced software from MaximizeMySocialSecurity.com and SocialSecurityChoices.com and the "AARP Social Security Calculator" available for free at http://www.aarp.org/work/social-security/social-security-benefits-calculator/.

Deborah Tedford (Mystic, Connecticut) points out that counter-intuitively, some studies show it is more important for those with fewer savings to delay Social Security than those with substantial assets (and other income). As average Americans age, their savings tend to diminish, and the higher monthly benefits become increasingly important.

g. **General Rules of Thumb For Decision of When to Begin Benefits**.

(1) **Earn a Lot**. Earn so much you don't need Social Security.

(2) **Still Working After Age 62**. Do not claim benefits before age 66 if you are still working and projected wages exceed the annual earnings limit ($15,720 in 2016).

(3) **Terminally Ill**. Begin benefits as soon as you can if you are diagnosed terminally ill or are very likely to die within 10 years. ("If wing gliding, claim earlier.")

(4) **Thirty-Five Years of Qualifying Wages**. If possible, delay benefits until you have 35 years of qualifying wages in the Social Security system.

(5) **Age 66**. Convincing people to wait past age 66 to begin benefits is difficult, but delaying wages to age 70 is advantageous if the individual anticipates living to approximately age 84.

(6) **Spend Savings If Necessary to Delay**. Spend savings after retirement to permit deferring benefits.

(7) **Unsure Whether to Delay**. If unsure, one possibility is to start benefits at age 68 and split the difference so that you only have to live to about age 78½ to recover the benefits foregone at ages 66 and 67.

(8) **Use It When You Can Enjoy It**. Cash flow at 66 may be a more "valuable" than having additional cash at age 85, if travel or other experiences may no longer be possible at age 85 (i.e., if you can no longer go scuba diving). ("I frankly don't care if I'm the richest guy in the nursing home.")

h. **Taxation of Retirement Benefits**. A portion of Social Security benefits may be subject to federal income taxes. The portion is based on the worker's "combined income" level, and whether the person files individually, files a joint return, or files married filing separately. The "combined income" is adjusted gross income + nontaxable interest (so investing in tax-free bonds does not help for this purpose) + ½ of Social Security benefits.

For persons filing a joint return, if the combined income of the worker and spouse is between $32,000 and $44,000, income tax is paid on up to 50% of the benefits, and if the combined income is more than $44,000, up to 85% of the retirement benefits are taxable. If some of the benefits are subject to income taxes, the worker can choose to make quarterly estimated payments or to have federal income taxes withheld from the benefits.

If a person will not begin taking distributions from IRAs or qualified plans before reaching age 70 ½ (when the required minimum distributions must commence), that may be a factor in deciding to start receiving Social Security benefits at age 66 if the worker would not have sufficient "combined income" between ages 66-70 to have to pay income tax on 85% of the benefits. (But if a worker has income at that low of a level, it is likely that the worker will have to begin taking distributions from IRAs to have sufficient income for basic support needs.)

i. **Spousal Benefits**. Very generally speaking, after a worker files for benefits, the spouse can apply to receive a benefit equal to 50% of the amount the worker would be entitled to receive at full retirement age (whether the worker is receiving benefits before or after age 66), but the spousal benefits are reduced permanently if the spouse has not reached his or her full retirement age. However, only one spouse at a time can claim spousal benefits.

After a worker has died, the surviving spouse is entitled to surviving spousal benefits after reaching age 60.

1. If the spouse elects to begin receiving survivor benefits before reaching his or her full retirement age, the survivor benefits are reduced (by 1-28.5% depending on how early the election is made).
2. If the worker had not started collecting benefits, the widow or widower benefit (assuming it is not reduced because of electing to receive it before the survivor's full retirement age) is 100% of the worker's "primary insurance amount" that would have applied when the worker reached full retirement age.
3. If the worker was receiving benefits at the time of his or her death, the widow or widower benefit will be equal to the amount the worker was actually receiving (again, unless reduced because the survivor elects to begin receiving benefits before his or her full retirement age). Thus, one of the advantages for a worker to defer applying for benefits until age 70 is to increase the "two-life annuity" available to the spouses from Social Security.
4. The widow or widower will lose the survivor benefits if he or she remarries before age 60 unless the subsequent remarriage ends. Remarriage after age 60 does not impact the entitlement to survivor benefits.

The Bipartisan Budget Act of 2015 impacted the Social Security claiming options of spouses. See Item 2.i of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

j. **Divorced Spouses**. Prior divorced spouses are also entitled to spousal benefits. Requirements are that the person was married to the worker for at least 10 years, the divorced spouse has not remarried, both are at least age 62, and they have been divorced at least 2 years. Payments made to a divorced spouse will not impact the amount of benefits payable to the worker or the worker's current spouse (or other divorced spouses of the worker who qualify for divorced spousal benefits).

A prior divorced spouse of a deceased worker is entitled to survivor benefits if the individual was married to the deceased ex-spouse for at least 10 years, if the individual is unmarried or married after age 60, and if the individual is at least age 60.

The spousal benefits and survivor benefits for divorced individuals do not appear on the "Earnings Record" and "Estimated Benefits" statement, and many divorced individuals are not aware of these benefits.

20. Electronic Wills Act

Traditionally, wills must be on paper, either typed (or printed) or handwritten. Nevada was the first state to adopt a statute recognizing electronic wills. NEV. STAT. ANN. §133.085(1)(a) (2016). Recently introduced Florida S.B. 206 and H.B. 277 allows persons to execute wills electronically without the physical presence of a witness or an attorney. At least three other states will likely introduce similar legislation in 2017. A growing trend of interest is appearing in this topic.

The Joint Editorial Board for the Uniform Trusts and Estates Act has recommended that the Uniform Law Commission form a drafting committee to address proposed uniform legislation governing electronic wills.

One issue to be addressed is how an electronic document will be authenticated. For example, the Nevada statute requires the testator's electronic signature and at least one "authentication characteristic," which the statute defines as "a reprint, a retinal scan, voice recognition, facial recognition, a digitized signature or other authentication using a unique characteristic of the person."

The Florida bill is simpler, requiring that the will exists in an electronic record, is electronically signed by the testator in the presence of either a notary public or at least two attesting witnesses, and is electronically signed by the notary public (and accompanied by a notary public seal) or both of the attesting witnesses "in the presence of" the testator and, in the case of witnesses, in the presence of each other. Individuals are deemed to be "in the presence of" each other if they are in the same physical location or in different physical locations that can communicate with each other by live video and audio conference (meaning they could be present with each other by Skype). However, another requirement in an amended version of the bill is that either the notary or both attesting witnesses must physically be in the "same room" as the testator. The signature requirement of any individual may be satisfied by an electronic signature. For an electronic will to be self-proved, a qualified custodian must be designated to control the electronic record, and the electronic will at all times must have been under the control of a qualified custodian before being reduced to the certified paper original that is sought to be probated. The bill was ultimately enacted with amendments, but the act was vetoed by the Governor, He expressed concern that the remote notarization provisions do not adequately ensure authentication of the identities of the parties, and could lead to overburdening the Florida court system with the probate of wills that have no Florida nexus other than that the wills were created and stored in Florida.

Concerns will also have to be addressed about the safety, confidentiality, and the possibility of fraudulent tampering.

21. Reporting Charitable Gifts on Gift Tax Return

Charitable gifts (even if less than the annual exclusion amount) are technically required to be reported on gift tax returns. Page 2 of the Form 709 Instructions states: "If you are required to file a return to report noncharitable gifts and you made gifts to charities, you must include all of your gifts to charities on the return."

If a donor has not previously reported charitable gifts on gift tax returns and the failure to do so was not willful, penalties are unlikely. (Penalties would be based on the amount of tax, but that is likely zero in any event.)

A reason for reporting charitable gifts on gift tax returns, even if penalties are not a concern, is that if more than 25% of a donor's gifts (charitable and non-charitable) are not reported on Form 709, the period of limitations for assessments is extended from three to six years. Reg. §1.6501(e)-1(b)(1). This is particularly important for gift tax returns reporting GRATs. Unless other substantial gifts are made during the year, the taxable gift resulting from a gift to a GRAT is likely very low (perhaps even $100 or less, despite the size of assets transferred to the GRAT). The omission of even small charitable gifts could cause the 6-year period of limitations on assessment of gift taxes to apply.

22. Trust as Owner of Another Trust, PLR 201633021

Letter Ruling 201633021 approves the fascinating concept of one trust being treated as the owner of another trust for income tax purposes under §678(a). In this ruling, Trust 1 and Trust 2 had the same beneficiaries and same distribution provisions. Trust 1 had the power to withdraw the income from Trust 2 each year, which power lapsed at the end of each calendar year.

Section 678(a) provides that a person other than the grantor shall be treated as the owner of any portion of the trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of Sections 671–677, subject a grantor of a trust to treatment as the owner thereof.

The IRS ruled that because of Trust 1's withdrawal right, Trust 1 was the deemed owner of the portion of Trust 2 over which it held the withdrawal power. Because Trust 1 had the power to withdraw the income of Trust 2, which Trust 2 defined as capital gains, as well as dividends, interest, fees, and other amounts characterized as income under §643(b), Trust 1 effectively was treated as the deemed owner of all the taxable income of Trust 2. Reg. §1.671-2(e)(6)Ex. 8 is consistent with this result. In that example, T1 transferred some assets to T2, retaining the power to revoke T2 and revest the assets in T1; the regulation concludes that T1 is treated as the owner of T2 under §678(a).

This result opens the possibility of having sale transactions between the trusts that would not be treated as taxable transactions. Could this be used to shift value from a non-exempt to a GST exempt trust? For example, a settlor might create a new trust (to which GST exemption would be allocated) identical to an existing non-exempt trust, and give the existing non-exempt trust the authority to withdraw or income or principal from the new trust. The existing trust would be treated as the owner of the new trust under §678, and could sell appreciating assets to the new GST exempt trust in a transaction that would not be a recognition event. For a further refinement of this alternative in connection with "BDOT" provisions, see Item 23.k below. (For an example of possible applications with GRATs, see Items 3.f and Item 11.d.(5) above.)

23. Creating Trust With Beneficiary As Deemed Owner Under §678, "Beneficiary Deemed Owner Trust" (BDOT); Application of Letter Ruling 201633021

a. Underlying Statutory Provision

Section 678 includes these relevant provisions:

(a) General Rule. –A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

(b) Exception Where Grantor Is Taxable. Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

b. **Overview Description of BDITs and BDOTs**.

What has been termed the "beneficiary defective inheritor's trust" (BDIT) by Richard and Steve Oshins, if a trust is not a grantor trust as to the trust's settlor and if a beneficiary has a Crummey power to withdraw **all of the contributions** to a trust, the beneficiary would be the deemed owner of the trust under §678(a)(1) during the period of time while the withdrawal power exists and arguably under §678(a)(2) after the withdrawal power has lapsed (or within the words of §678(a)(2) has been "partially released" assuming the lapse is treated as a release for §678 purposes). *See, e.g.,* Richard A. Oshins, *The Beneficiary Defective Inheritor's Trust ("BDIT"): Finessing the Pipe Dream*, CCH Practical Strategies (Nov. 2008); Jonathan Blattmachr, Mitchell Gans & Alvina Lo, *A Beneficiary as Trust Owner: Decoding Section 678,* 35 ACTEC L.J. 106 (Fall 2009). The approach uses withdrawal powers over the **entire contribution** to the trust and **relies primarily on §678(a)(2)** following lapses of the withdrawal powers. Under this approach, relatively small gift transfers (typically $5,000) are made to the trust so that the lapse of the withdrawal power does not result in the beneficiary being treated as having made a transfer to the trust, which would cause partial estate inclusion in the beneficiary's estate. The practical problem with the BDIT is how to leverage a small $5,000 gift to a trust into a significant size through later transactions with the trust. (See paragraph m below for a further discussion of BDITs and potential planning concerns with BDITs.)

Ed Morrow suggests another approach, in which the beneficiary has the right to withdraw an amount equal to **all of the trust's taxable income** in any given year (from all of the trust assets) but does **not have the right to withdraw the entire contribution** to the trust. The approach **relies primarily on §678(a)(1)** because the beneficiary holds a withdrawal over taxable income *each* year. This approach does not have the limitation of allowing only small gifts to the trust; gifts of any size could be made to the trust because there is no concern of keeping the entire contribution within the "5 or 5" power amount. Mr. Morrow calls this a "beneficiary deemed owner trust ("BDOT"). For an outstanding summary and analysis of this approach, see Ed Morrow, *IRC 678(a)(1) and the "Beneficiary Deemed Owner Trust" (BDOT)*, LEIMBERG ESTATE PLANNING NEWSLETTER #2516 (Sept. 5, 2017).

c. **Why the BDOT Works Under §678(1)(1)**. Observe the highlighted words below in §678(a)(1):

> "A person other than the grantor shall be treated as the owner of **any portion** of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus **or the income** therefrom in himself…"

The BDOT approach is based primarily on the "**OR income**" phrase in §678(a)(1).

> It is easy to ignore or misinterpret the "power … to vest … the income" portion of §678(a)(1), since there have been fewer reported cases, ruling and articles on trust structures that only allow withdrawal powers over taxable income, yet dozens of PLRs and articles on withdrawal powers over corpus. Treatise have very little if any discussion of this potential variation.
>
> **Yet**.
>
> *But there is no reason to ignore the "or the income" in the statute and no requirement under §678(a)(1) that a beneficiary/powerholder have any power over corpus beyond the income attributed to corpus to shift all the income taxation to the beneficiary. Id.*

"Income" in §678 Means Taxable Income. The regulations governing the grantor trust rules (§§671-679) clearly provide that the reference to "income "unless specifically limited, refers to income determined for tax purposes and not to income for trust accounting purposes. Treas. Reg. §1.671-2(b). (In contrast, for purposes of the non-grantor trust provisions of Subchapter J (Parts A-D, F), a reference to income generally means trust accounting income. Treas. Reg. §1.643(b)-1.)

Withdrawal Power Should Exist Over All Taxable Income. In order for the beneficiary to be treated as the owner of the entire trust for income tax purposes under §678(a)(1), the withdrawal power must apply to all net taxable income during the year, including capital gains. If a trust agreement merely provides that the beneficiary may withdraw "income," under state law principles that would generally refer to income determined for trust accounting purposes which would not typically include extraordinary dividends or capital gains. To cause the taxable income attributable to the corpus portion of the trust also to be treated as owned by the beneficiary, the withdrawal power must apply with respect to an amount equal to all of the net taxable income. Having the corpus portion of the trust being treated as owned by the beneficiary for income tax purposes is extremely important if the beneficiary wishes to sell assets to the trust and have the transfer treated as a non-recognition event under the reasoning of Rev. Rul. 83-12.

Case Law and Letter Ruling Support. Case law supports the conclusion that a power to withdraw taxable income attributable to trust principal, without the power to withdraw the principal itself, causes the powerholder to be taxable on the taxable income attributable to trust principal. *Campbell v. Commissioner*, T.C. Memo 1979-495 (beneficiaries had the power to cause the trustee to distribute capital gains; beneficiaries did not request and the trustee did not distribute the capital gains income to the beneficiaries, but they "were deemed to be the owners of the capital gains income" under §678(a)(1)).

Private letter ruling 201633021 (discussed in Item 22) also supports this conclusion. In that ruling, trust #1 had the power to withdraw from trust #2 "any dividends, interest, fees and other amounts characterized as income under §643(b) of the Code" and the net short term capital gains and the net long term capital gains. Trust #1 did **not** have the power to withdraw principal of trust #2 beyond the taxable income. The ruling concluded that all of the taxable income of trust #2, including the net capital gains, were taxed to trust #1 under §678(a)(1).

Whether Taxable Income Amount Is Actually Withdrawn Is Irrelevant Under §678. Income is taxable to a powerholder under §678(a)(1) whether or not the amount is actually withdrawn. If it is withdrawn, such withdrawal is generally a non-taxable event because it is not a distribution that is reported under the distribution rules for non-grantor trusts. Rev. Rul. 67-241. Indeed, §678(a)(1) applies if the powerholder is a minor for whom a guardian who could exercise the power has not been appointed. Rev. Rul. 81-6; *Trust No. 3 v. Commissioner*, 285 F.2d 102 (7th Cir. 1060). Failure to withdraw the portion of taxable income that exceeds the greater of $5,000 or 5% of the trust assets, however, could have an effect for transfer tax purposes and for purposes of creditor access to the trust assets, as discussed below.

d. **Withdrawal Power Over Net Taxable Income Amount Should be Exercisable From All Trust Assets; Impact of Lapse of Withdrawal Power in Excess of "5 or 5" Power**. The trust agreement may provide that failure to withdraw the taxable income amount in a particular year would lapse and could not be exercised in a later year. If so, and if the lapsed power exceeds the greater of "(A) $5,000, or (B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied," the power holder will be treated as having made a gift of the excess amount (unless it is an incomplete gift because of retained powers over the trust) [*see* §2514(e)], and the portion of the trust attributable to such excess amount would be included in the powerholder's gross estate for estate tax purposes [*see* §2041(b)(2)].

For most years, the net taxable income of a trust will be less than 5% of the trust value. To use the full trust value in order the measure the 5% amount, the beneficiary should be able to withdraw the net taxable income amount from all of the trust assets. *See* Rev. Rul. 66-87 (where beneficiary had the power to withdraw accounting income, the 5% element is calculated based just on the accounting income, not all trust assets, reasoning that "the annual trust income … is 'the assets out of which … the exercise of the lapsed powers could have been satisfied'" and apparently assuming that that the trust agreement did not permit the withdrawal power to be satisfied from all trust assets).

If the amount of the net taxable income that can be withdrawn in a particular year exceeds the "5 or 5" amount, the preferred approach would be either (a) for the powerholder to withdraw such excess amounts, or (b) for the withdrawal power to include a "hanging power" so that the amount lapses year only up to the "5 or 5" amount. If the beneficiary has continuing aggregate unlapsed powers, the beneficiary's estate would include that full amount in the beneficiary's gross estate at the beneficiary's death.

e. **Spendthrift Protection Issues**. The beneficiary's creditors ordinarily could not reach assets in a third-party spendthrift trust. Does that change because the beneficiary had the power to withdraw assets from the trust; is the beneficiary treated as a transferor to the trust as to that portion of the trust? If so, the trust may nevertheless be protected from the beneficiary's creditors if a state "self-settled trust" law applies. Even if the trust does not provide creditor protection for all self-settled trusts where the settlor is a discretionary beneficiary, almost all states treat the withdrawal powers that were within the "5 or 5" amount as not causing the beneficiary to be treated as having made a transfer to the trust for creditor access purposes. *E.g.,* Tex. Prop. Code §112.035(e) (lapse in any year not exceeding 5 or 5 amount [or gift tax annual exclusion amount if greater]) & §112.035 (f)(B)(3) (present withdrawal power not exceeding 5 or 5 amount). *See* Ed Morrow, *IRC 678(a)(1) and the "Beneficiary Deemed Owner Trust" (BDOT)*, LEIMBERG ESTATE PLANNING NEWSLETTER #2516 n.64 (Sept. 5, 2017)(also references a 50-state survey chart prepared by Mr. Morrow regarding trust assets subject to withdrawal powers).

f. **Not A Grantor Trust as to Settlor**. The normal grantor trust rules typically "trump" §678. Section 678(b) provides that "Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section." The reference in §678(b) to "income" means taxable income (as discussed in paragraph c above), so §678(a) would clearly not apply to a power to withdraw taxable income if the trust is otherwise a grantor trust as to the original settlor of the trust.

g. **Testamentary Trust of Which Surviving Spouse is Deemed Owner Under §678.** Following a spouse's death, testamentary trusts created for the surviving spouse could be treated as owned by the surviving spouse for income tax purposes, allowing the surviving spouse to enter into sale transactions with the trusts without incurring recognition events and to allow the surviving spouse to pay the ongoing income tax of the credit shelter trust to build more value in the trust that would pass free of estate tax at the surviving spouse's subsequent death. (For a QTIP trust, the withdrawal power should include the greater of the net taxable income or the trust accounting income in order for the trust to satisfy the qualifying income interest for life requirement of a QTIP trust. *See* §2056(b)(7)(B);Treas. Reg. §20.2056-7(d)(2) making reference to §20.2056-5(f), including §20.2056-f(8) (spouse has the right exercisable at least annually to require distribution to herself of the trust income).

If both the credit shelter trust and the marital trusts are treated as owned by the surviving spouse for income tax purposes under §678, the credit shelter trust could engage in estate freezing transactions with the marital trust to shift future appreciation from the marital trust to the credit shelter trust (to minimize estate inclusion at the surviving spouse's subsequent death and to maximize accumulations in the GST exempt trust) but without having a current recognition event for income tax purposes.

h. **Broad Use For Beneficiaries of Testamentary Trusts.** This approach might be used broadly for testamentary trusts, to permit the beneficiary to have the flexibility of entering into transactions with the trusts and to allow the trusts to grow more quickly by having the beneficiary pay income taxes with respect to trust income with the beneficiary's outside assets (to maximize the amount that would be excluded from the beneficiary's estate and to maximize the amount that might accumulate in GST exempt trusts). To the extent that the beneficiary did not want to pay the income tax with outside assets, the beneficiary could exercise the withdrawal power over a sufficient amount to pay the income tax attributable to the trust income.

i. **Use With Inter Vivos Trusts.** The BDOT approach could be used for inter vivos trusts as well. To the extent that the trust is legitimately created and funded by a third party, the trust would be treated as owned by the beneficiary for income tax purposes in future years. Thus, the trust would achieve the general advantages of the BDIT trust, but the severe restrictions on the amount that could be funded into a BDIT would not apply. The BDOT could be funded with a large enough amount so that the beneficiary could sell assets to the trust under a traditional "rule of thumb" approach of having 10% equity in the trust without the necessity of using guarantees or other approaches to justify having the trust purchase substantial assets from the beneficiary in return for large notes from the trust.

Alternatively, a "standard" inter vivos grantor trust could provide that following the grantor's death, the beneficiary would have the withdrawal power over all taxable income or grant a protector the authority to grant such a withdrawal power to a beneficiary. The trust would be a grantor trust as to the original grantor for the grantor's lifetime and thereafter the trust would be (or could be if the protector granted the beneficiary a withdrawal right over taxable income) deemed to be owned by the beneficiary/powerholder under §678.

j. **Administrative Advantage–Eliminate Need to File Fiduciary Income Tax Returns.** If the trust is a grantor trust as to the beneficiary under §678, the trust would not need to file a complete fiduciary income tax return (Form 1041) each year. Some planners may view this as a primary advantage of structuring the trust to be a grantor trust as to the beneficiary.

   If a grantor trust files a Form 1041, the form is left blank, and a statement is attached indicating the income and deduction information that has been communicated to the deemed owner for inclusion on the deemed owner's Form 1040. The grantor trust box on the Form 1041 should be checked. In some circumstances, no Form 1041 need be filed (and the trustee of the trust does not need to obtain a taxpayer identification number). *See* Reg. § 1.671-4(b).

k. **Protector Powers to Afford Flexibility.** To address the concern that a beneficiary might repeatedly actually imprudently exercise the withdrawal power, a protector could have the ability to eliminate the withdrawal power going forward (similar to the provision allowing a donor to the trust to provide that a Crummey withdrawal power would not apply as to particular future gifts to the trust).

l. **Advantage of BDOT Provisions With Trust Planning Under PLR 201633021**. If an existing trust (T1) is not exempt from the GST tax, one planning approach would be for someone (likely the same donor) to create a new trust (T2) that would be almost identical to T1 and that would give the existing non-exempt T1 the ability to withdraw an amount equal to the entire taxable income (including capital gains) from the assets of T2. GST exemption would be allocated to T2. T2 would be funded with enough assets to justify a substantial purchase of assets (i.e., within the "10% equity folklore safe harbor"). T1 might subsequently sell appreciating assets to T2 in return for a fixed relatively low-interest note, to (hopefully) shift value to the exempt T2 over time. The sale would not be a recognition event because T1 would be the deemed owner of T2 under §678. PLR 201633021 (indeed, under the facts of that ruling, T1 only had the power to withdraw taxable income including capital gains income from T2). If T1 had the power to withdraw all of the assets from T2 and did not do so, query whether that would be treated as some type of contribution to the exempt T2 requiring GST exemption allocation to prevent T2 from becoming partially non-exempt. That potential GST exemption allocation issue does not exist if T1s withdrawal power is limited to the taxable income and if the trust has a hanging withdrawal power so that all such withdrawal powers can be lapsed out within the 5 or 5 amounts. In that manner, T1 would never be treated as having made a transfer to T2, thus not raising the issue of a "transferor" allocating GST exemption. *See* Reg. §26.2652-1(a)(5)Ex.5 (lapse of withdrawal right not exceeding 5 or 5 amount not treated as a transfer to the trust; original settlor is still treated as the transferor to the trust).

m. **Potential Concerns with BDIT Transaction**. A number of IRS private letter rulings treat the holder of a Crummey power as the owner of the portion of the trust represented by the withdrawal power under §678(a)(1) while the power exists and under § 678(a)(2) after the power lapses if the power holder is also a beneficiary of the trust. *See e.g.* Ltr. Ruls. 201039010, 200949012, 200147044, 200104005, 200022035, 200011058, 200011054 through 200011056, 199942037, & 199935046. Even so, potential technical concerns may arise with BDITs. *See generally* Luke T. Tashjian, *The Use of Beneficiary Defective Trusts in Modern Estate Planning*, 48 REAL PROP., TRUST AND EST. L.J. 353 (Fall 2013).

The BDIT transaction is not on the Treasury Priority Guidance Plan, but the IRS has expressed concern with the "BDIT" in two ways. The IRS added the "sale to a BDIT" transaction to its "no-ruling" list for the first time in 2013. Rev. Proc. 2013-3, 2013-1 I.R.B. 113, §4.01 (43, 48-52) (no rulings as to §§678, 2035, 2036, 2037, 2038, and 2042). In addition, the sale to grantor trust legislative proposal that was included in prior administration budget proposals specifically refers to the "deemed owner under the grantor trust rules," which undoubtedly is a reference to trusts treated as being owned by the beneficiary under §678. This is the IRS's "shot across the bow" suggesting that the IRS is questioning the BDIT concept, though not expressing reasons why it does not work. A particular focus of the IRS will be to determine how a trust goes from having a value of $5,000 from an initial trust contribution to having a value of millions of dollars through highly leveraged transactions.

For a more complete discussion of the BDIT transaction, see Item 31 of the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.Bessemer.com/Advisor**.

24. Conversion of CLAT to Grantor Trust, PLRs 201730012, 201730017, and 201730018

In PLRs 201730012, 201730017, and 201730018, a CLAT was amended to give the grantor's brother a substitution power. One of the ruling requests is whether the conversion of the trust from a nongrantor trust to a grantor trust (assuming the substitution power is found to be held in a non-fiduciary capacity) is a taxable transfer from the trust to the grantor. The ruling concluded that the conversion from nongrantor trust to grantor trust status is not a taxable transfer for income tax purposes. The ruling observed that Rev. Rul. 85-13, 1985-1 C.B. 184 involved the conversion of a nongrantor trust to a grantor trust (by the grantor's acquisition of trust assets in return for a note from the grantor, which the ruling viewed as an indirect borrowing of the trust corpus by the grantor). Rev. Rul. 85-13 concluded that the transfer was not a sale for income tax purposes and the grantor did not acquire a cost basis in the assets. This ruling is consistent with CCA 200923024 which similarly concluded (in a ruling involving an abusive transaction) that the conversion of a nongrantor trust to a grantor trust was not a taxable transaction, noting that treating the conversion as a taxable transaction would have an impact on non-abusive transactions.

The PLRs also concluded that the conversion is not an act of self-dealing under the private foundation rules because the grantor's brother (who held the substitution power) is not a disqualified person under §4946(a). In addition, the trust was not entitled to a charitable deduction because the conversion was not recognized as a transfer at all for income tax purposes.

25. Intergenerational Split Dollar Life Insurance Plan Qualified for Economic Benefit Regime Under Split Dollar Regulations, *Estate of Morrissette v. Commissioner*

a. **Synopsis of *Estate of Morrissette v. Commissioner***. The Tax Court, in a "regular" opinion of the full court, approved an intergenerational split dollar life insurance arrangement in which Mrs. Morrissette (actually her revocable trust) paid large lump sum premiums ($29.9 million) for Dynasty Trusts to purchase universal life insurance policies on the lives of her three children. Under the split dollar agreement, as each of the children died, the revocable trust was entitled to receive the aggregate premiums paid (without added interest) on the policies on that child's life (or the cash surrender value of such policies, if greater [but the cash values may be lower than the aggregate premiums paid, because the cost of insurance and other costs of maintaining the policies in force would be charged against the policies each year]). Following Mrs. Morrissette's death, her estate included her reimbursement rights under the split dollar arrangements in her estate, at a value of about $7.5 million (compared to the $29.9 million lump sum premiums she had paid), in light of the fact that her revocable trust would not receive the payments for many years in the future (as her children died—actuarially expected to be about 15 years later).

   The court granted partial summary judgment, holding that the technical requirements in the regulations for applying the economic benefit regime were satisfied. The court's analysis waded through the hyper-technical details of the split dollar regulations. The central issue under the court's analysis is its conclusion that the Dynasty Trusts had no current access to the cash values of the policies and received no additional economic benefit other than current life insurance protection. *Estate of Morrissette v. Commissioner,* 146 T.C. No. 11 (2016) (appealable to Fourth Circuit).

   The court did not address the valuation issue or other issues raised by the IRS. (The IRS maintained in the Notice of Deficiency that the full $29.9 million premium advance should be treated as a gift.) The other issues will be addressed following this partial summary judgment decision. For a detailed discussion of the analysis in *Morrissette*, see Item 27.b-e of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

b. **Brief Background About Discount Intergenerational Split Dollar Insurance**. Under traditional split dollar arrangements, a donor funds premiums on a policy on the *donor's* life, and the premium advances are repaid at the donor's death from the policy death proceeds. In contrast, under intergenerational split dollar arrangements, a parent pays premiums on a policy insuring a *child* (or *grandchild's* life), and the premium advances are not repaid until the insured's death, which could be decades in the future. If the reimbursement right is transferred by the parent (by gift or sale or as an asset of the donor's estate at her death), a substantial discount may apply in determining the *present* value of the reimbursement right, which might not be repaid for decades. (The *present value* of the right to a set dollar amount, to be paid decades in the future, would obviously be much smaller than the aggregate payment that would be made many years in the future.)

Taxing intergenerational split dollar insurance under the economic benefit regime is helpful in supporting a substantial discount on the value of the receivable; under the economic benefit regime the parent just receives the aggregate premiums paid or cash surrender value if greater (and is treated as making a transfer each year of the current value of life insurance coverage), but under the loan regime the reimbursement right would be for the premiums paid *plus interest* that would accrue over the many years before the repayment is made.

c. **Planning Considerations**. For an overview of planning issues regarding intergenerational split dollar life insurance, see Lee Slavutin, *A Post-Morrissette Roadmap for Drafting Intergenerational Split Dollar Agreements*, LEIMBERG ESTATE PLANNING NEWSLETTER #2414 (May 12, 2016); Alan Jensen & R. Brent Berselli, *Estate of Morrissette: Unfinished Business,* LEIMBERG ESTATE PLANNING NEWSLETTER #2418 (May 23, 2016) (hereinafter "Jensen & Berselli, *Unfinished Business*")*;* Lee Slavutin & Richard Harris, *Intergenerational Split Dollar Life Insurance; What Can We Learn from* Morrissette, Levine *and* Neff?, LEIMBERG ESTATE PLANNING NEWSLETTER #2443 (August 9, 2016); Espen Robak, *Intergenerational Split Dollar Valuation Issues,* LEIMBERG ESTATE PLANNING NEWSLETTER #2444 (August 9, 2016).

(1) **Significance; Only One Narrow Issue in *Morrissette***. *Morrissette* is important because it is the first court case addressing intergenerational split dollar insurance, and it is a taxpayer victory by the full Tax Court. But the court addresses only one narrow issue (on the taxpayer's motion for partial summary judgment as to that narrow issue), and the IRS is no doubt advancing a variety of other issues in the case (in addition to the valuation issue).

Many questions remain regarding the tax treatment of intergenerational split dollar insurance; it is not widely used (just by some very wealthy families), and the IRS may continue to address other ways to fight the overall result of a transfer with a huge discount (the IRS's brief characterized the plan as an effort to "minimize the taxable estate"). Nevertheless, this initial decision is a significant development regarding intergenerational split dollar agreements.

(2) **Other Potential IRS Attacks**. A variety of potential issues, other than whether the economic benefit regime applies, exist regarding intergenerational split dollar arrangements. Some of these other issues are:

1. Treatment of insurance coverage following premium payer's death;
2. Section 2703 – (the taxpayers in *Morrissette* have filed a motion for partial summary judgment that §2703 does not apply);
3. Sham transaction; lack of business purpose.
4. Step transaction – this is the position that it is taking in *Estate of Marion Levine v. Commissioner,* T.C. No. 9345-15 (petition filed April 8, 2015) ("transfer … constituted gifts … in a series of interrelated steps with a value equal to the cost of the … premiums paid"); the Tax Court entered summary judgment in favor of

the taxpayer on July 13, 2016 in *Estate of Levine,* resulting in no gift tax deficiency or penalties, on the basis of the *Morrissette* opinion;

5. Modification under the split dollar regulations;

6. Sections 2036 and 2038; and

7. Duty of consistency.

For a discussion of the IRS attacks under each of these arguments, see Item 27.f.(2) of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

(3) ***Estate of Cahill v. Commissioner;* Arguments in Subsequent Litigation in *Morrissette***. A new case that has been filed in the Tax Court is illustrative of additional issues that arise with intergenerational split dollar insurance. *Estate of Cahill v. Commissioner,* T.C. No. 10451-16 (petition filed May 3, 2016). Issues raised by the IRS in that case include:

8. Property paid to the trust (to pay premiums) is included in the decedent's gross estate under §§2036(a)(1) and 2036(a)(2), and the transfer was not a bona fide sale for adequate and full consideration;

9. Certain provisions of the split-dollar agreement constitute a restriction on the right to use or sell the decedent's property, or an option, agreement, or other right to acquire or use decedent's property at a price less than fair market value under §2703;

10. Property paid to the trust is included in the gross estate under §2038; and

11. Under §2043, the excess of the fair market value at the time of death of property otherwise included under §2038 or §2035 over the value of the consideration received by decedent was included in the gross estate.

The *Cahill* facts involve the added complexity of the grandparent borrowing from a third party lender to acquire cash to make the premium payment under the split dollar arrangement. In that scenario, the IRS may question why anyone would agree to repay the bank dollar for dollar (plus interest) in return for merely receiving the highly discounted reimbursement right.

In *Morrissette* ¸the taxpayer filed a motion of summary judgment in the Spring of 2017. In response, the IRS argues not only the valuation of the reimbursement right, but also makes arguments under §§2036, 2038, and 2703. The IRS takes the position that the "bona fide sale for full consideration" exception in §§2036 & 2038 does not apply to intergenerational split dollar arrangements; the payment of the policy premium is not a "sale" but an investment (so no bona fide "sale" exists), and the transfer is not made for full consideration.

(4) *Estate of Johnson* Favorable Settlement. *Estate of Johnson v. Commissioner*, T.C. No. 11708-16 (filed May 16, 2016) involved a SCIN (in which the seller died before the balloon principal payment was due) and $10 million and $5 million life insurance policies financed by a third-party lender and a private split-dollar arrangement. That case has now been settled, very largely in the taxpayer's favor.

The IRS settled for a $969,761 deficiency in a stipulated decision entered in the Tax Court on August 30, 2017. *See* Erin McManus, *former Bookkeeper's Estate Mostly Wins on Complex Plan,* BNA Daily Tax Report (September 1, 2017). (The estate was represented by Gregory Densen and Christopher Cole, Denver, Colorado).

(5) **Valuation of Receivable**. The court in *Morrissette* made clear that it was not addressing the value of the receivable in the partial summary judgment decision; that will be addressed subsequently. However, at least one commentator predicts that "*Morrissette* will not proceed to a decision on the merits of the valuation of the [split dollar] receivable. There is simply too much at stake to be wrong–for the taxpayer and the IRS. We faced a similar dilemma and ultimately settled on a discount of 35% as opposed to our claimed 95%." *See* Jensen & Berselli, *Unfinished Business.*

In the case referenced by Jensen and Berselli, G-1 advanced premiums to life insurance trusts to purchase life insurance on the lives of G-1's children (G-2). The split dollar receivables were reported on the decedent's estate tax return on the basis of independent valuations of the split dollar receivable, which considered the decedent's restricted access to repayment as well as the actuarial life expectancy of each of the insureds. The receivables were reported with a 95% discount–and the parties settled at a 35% discount.

In *Cahill,* the values reported on the estate tax reflected about a 98% discount compared to the value asserted by the IRS. An independent appraiser (WTAS, LLC, now Anderson Tax) valued the receivable using the discounted cash flow method using a discount rate of 15%.

Some planners have reported settlements with discounts of 65%-90%.

One appraiser examines empirical data from lottery prize transactions, private note transactions, structured settlement transactions, and life settlement transactions to determine an appropriate discount factor for valuing intergenerational split dollar loans. He observes that one company that manages a portfolio of 600 policies acquired in life settlement transactions reports discounts rates ranging from 15.0% to 24.5%, with a weighted average discount rate of 17%. Espen Robak, *Intergenerational Split Dollar Valuation Issues,* LEIMBERG ESTATE PLANNING NEWSLETTER #2444 (August 9, 2016).

(6) **Loan Regime Arrangements**. A general trend is emerging among planners using intergenerational split dollar to prefer the loan arrangement for various reasons. *See* Lee Slavutin & Richard Harris, *Intergenerational Split Dollar: What Can We Learn from* Morrissette, Levine *and* Neff?, LEIMBERG ESTATE PLANNING NEWSLETTER #2443 (August 9, 2016) (loan treatment can be assured, loan can be for life of insured allowing lock in of low interest rate, easier to understand, all variables locked in at outset, large history of loan receivables being valued at a discount, and no report of any intergenerational split dollar loan regime cases being audited). The IRS so far has not been auditing loan regime arrangements. The discounts may not be as large as under the economic benefit regime, but planners suggest that significant advantages may still be available. (For example, significant discounts may still apply because the interest rate on the loan may be much lower than the discount rate that an appraiser will apply in valuing the note.) One planner reports settling an intergenerational split

dollar loan under the loan regime with a 65% discount. Other planners acknowledge that discounts are lower under the loan regime approach, but only nominally so.

(7) **Sale of Receivable**. A sale of the receivable during the donor's life may reduce the likelihood of the IRS raising other arguments summarized in Subparagraph (2) above on an audit of the donor's estate tax return if the return merely includes cash or another note that makes no reference to a life insurance policy.

(8) **Summary by Steve Leimberg.** The following excellent summary by Steve Leimberg summarizes current practices and suggests best practices from a planning standpoint.

> In my opinion the summary judgment granted the taxpayer in *Morrissette* was a relatively minor issue that the IRS had very little hope of winning. The pre-eminent issue concerns the appropriateness of the discount taken. That issue has yet to be decided, and my guess is that it's likely that issue isn't settled and we will see no formal opinion on the valuation issue. Having said that, my understanding is that the other [generational split dollar] cases I've been following have been settled on this issue (sometimes with pretty generous results). I've heard there are around 20 or so [generational split dollar] cases currently under audit, with several on the tax court docket. All of these cases currently under audit were apparently done using the economic benefit regime. (It does not appear the Service is challenging cases done under the loan regime.) … That makes the safer course of action use of the loan regime.
>
> Inter-generational split-dollar may be troublesome to some insurance carriers — mainly because of the persistency risk. As we've seen so many times in the past, insurance purchases that are not intended to meet a legitimate life insurance need of the younger generation, but rather, are designed to move money from the older generation to the younger generation with minimal transfer tax consequences generate problems. In too many instances, the funds are being paid into the policy as a single premium (even ignoring the fact that putting a collateral assignment on a MEC policy is a bad idea due to Code sections 72(e)(10) and 72(e)(4)). In addition, the policies were designed to have a high early cash surrender value, oftentimes utilizing riders to accomplish this. Once the split dollar receivable was transferred (either by gift or at death) and the discount taken, then the policies were generally immediately surrendered for their cash value by the younger generation. This surrender generally took place within 2-5 years. … The persistency risk is that a carrier's breakeven point may not be until year 8 or 9, and carriers are in business to make a profit, not merely to break even. So the [generational split dollar] arrangement described above would be bad business" for carriers, and clients and producers are profiting using a "sham transaction" to the detriment of life insurance carriers.
>
> Bottom Line:
>
> I believe there is still significant tax and legal risk involved in inter-generational split-dollar. I do not believe Morrissette changed that. I do feel that risk can be alleviated somewhat by using the loan regime, holding the receivable until the death of the second generation rather than gifting it, structuring the policy as a non-MEC, and ensuring that there is a legitimate need for the insurance.
>
> Caution: Even those precautions may not be adequate in situations where the arrangement is entered into primarily as a means to transfer funds from one generation to the next with minimal transfer tax consequences and the intent is to surrender the policy after the transfer of the split dollar receivable. Such abusive uses of [generational split dollar] remain subject to IRS attack as a sham transaction. In addition, insurance carriers generally have no appetite for such bad persistency business and are increasing screening for such arrangements in an attempt to prevent the use of their products with them.

Comments by Steve Leimberg appearing in Jensen & Berselli, *Unfinished Business*.

26. New Procedure for Release of Special Automatic Estate Tax Lien

The general estate tax lien arises under §6324(a) on all property includible in the decedent's estate for 10 years. The general estate tax lien does not have to be recorded; it is automatic. If the collateral for the lien is property of the estate, the automatic estate tax lien under §6324(a) on that property is extinguished by the special estate tax lien for §6166 deferred tax under §6324A.

For PROBATE assets, property that is purchased or transferred is still subject to the lien in that person's possession, except that if property is transferred to a purchaser or holder of a security interest and if the executor has been discharged from personal liability for the estate tax under §2204, the lien no longer applies to the transferred property but the lien attaches to the consideration received from the purchaser. §6324(a)(3). For that reason, any purchaser of probate property should request documentation that the executor has been discharged from personal liability under §2204 or request that the IRS release the lien. (Despite the existence of this automatic lien, however, many purchasers of real estate do not request a lien discharge.)

For NONPROBATE assets, the rules are quite different, as illustrated in Legal Advice Issued by Field Attorneys (LAFA) 20061702F. Nonprobate property transferred to a purchaser or holder of a security interest is no longer subject to the lien; however a like lien attaches to all of the transferor's property. §6324(a)(2). The specific issue in LAFA 20061702F was whether pledging property was a "transfer" for purposes of this special rule that divested transferred property of the lien. The LAFA held that it was. It pointed out, though, other special rules that apply for nonprobate property under §6324(a): (1) The beneficiary is personally liable for the estate tax; (2) The lien remains to the extent that the value of the collateral exceeds the balance of the loan to the lender; and (3) There is a lien against the beneficiary's property.

New Procedure Instituted in 2016. Prior to June 1, 2016, obtaining a discharge was fairly straightforward; the lien would typically be released with 10 days of sending the Form 4422 to the IRS (or hand delivering it to a local IRS estate and gift tax office). Significant changes in the procedures for estate tax lien discharges were instituted beginning June 1, 2016. The IRS Collections Advisory Group is now handling applications for certificate of discharge of property subject to the estate tax lien; these were formerly handled by the local IRS Estate and Gift Tax Groups. Under the new procedures all sale proceeds must be paid to the IRS or placed in escrow. The only permitted reductions seem to be for amounts needed to satisfy mortgages and "reasonable" selling expenses.

The IRS has issued a revised Form 4422, Application for Certificate Discharging Property Subject to Estate Tax Lien, which must be submitted to the IRS along with the supporting documents described in the instructions to Form 4422. (The form is dated September 2016.) The attorney will need to supply the IRS with a title insurance commitment showing the legal description. The instructions provide: "If the property consists of real estate, attach a separate legal description and a preliminary title report for each parcel." The estate will have to produce evidence that the selling price is a fair price, such as with an appraisal or perhaps a letter from a real estate broker who is knowledgeable about the market and comparable properties. The instructions to Form 4422 say to "show the value of the property and the basis of the valuation." The form should be submitted "at least 45 days before the transaction date."

If an escrow approach is used, the IRS will supply an escrow agreement (and it will not agree to any changes to the agreement). The IRS must approve the escrow agent, and one of the requirements is that the escrow agent be bonded. Provide the IRS with a draft of the closing statement showing the net sale proceeds, so the IRS manager can prepare the escrow agreement. The escrow agreement will reflect the legal description of the property for which the discharge is requested, and the net sale proceeds. The IRS will fax (but not email) the escrow agreement, which must be signed by the personal representatives, the escrow agent, the IRS manager in charge of this new process, and that IRS manager's supervisor (and the manager and supervisor are located are different cities). The process of finalizing the escrow will take some time; do not wait until close to the closing to begin the process.

The IRS will initially issue a conditional commitment, which will allow the sale to close. The actual certificate discharging the lien is not issued until the IRS has confirmation that the funds are in the possession of the escrow agent.

If the escrow approach is used, an estate tax closing agreement is required to obtain the release of the funds. Query whether a transcript with the code "421" will suffice for this purpose? Notice 2012-12 suggests that it would. (See Item 5.e above.)

This summary includes information provided by Laird Lile (an attorney in Naples, Florida) in a Florida Bar Real Property Probate and Trust Law Section newsletter and in subsequent updates. He indicates that the IRS manager in charge of this new process (as of March 7, 2017) is Kim Harris (904-661-3276).

IRS officials have indicated informally that the shift of the lien release process to the IRS Collections Advisory Group was merely a resource allocation decision with no intention to change the existing procedure. The changed procedures may simply reflect the general lien release procedures used by the Collections Group. The December 29, 2016 Federal Register published a request for comments on Form 4422. An IRS official who is looking at the revised policy asked Randy Harris (New York) to supply examples of estates that have had problems with this revised procedure. An internal memorandum dated April 5, 2017, entitled "Memorandum for Director Specialty Collection, Offers, Liens & Advisory - Director Special Examination Estate & Gift Tax" describes some relaxation of the situations in which the lien waiver would be granted. The memorandum anticipates "that this or similar guidance will be incorporated into the [Internal Revenue Manual]." The IRS may issue a revised Form 4422 with revised instructions.

Under the relaxed procedures described in the April 5, 2017 Memorandum, collection officers are reminded that under §6325(c), a certificate of discharge of the lien may be issued "if the Secretary finds that the liability secured by such lien has been **fully satisfied or provided for.**" (emphasis included in the quotation of the section in the Memorandum). The Memorandum describes various situations in which the officer may exercise its discretion to issue the certificate of discharge because the estate tax liability "has been fully satisfied or provided for." Those situations include:

- The estate is not required to file an estate tax return (in which event "Letter 1352" is issued in lieu of a certificate of discharge);
- The Form 4422 indicates that the estate is non-taxable based on the estimated gross estate and estimated deductions (but if the collection officer has a question regarding the effect of any deductions, the officer should submit the application to the Examination Estate & Gift group before making a decision):

- The estate filed an extension request and paid the full estimated estate tax (but if the collection officer has a question regarding the effect of any deductions, the officer should submit the application to the Examination Estate & Gift group before making a decision);
- The estate filed Form 706 and paid the reported tax (but the collection officer "*should submit* an SRS [i.e., Specialist Referral System] referral to Examination Estate & Gift before making a decision on the application" regarding the estate tax computation or questions regarding the effect of any deductions);
- The remaining property of the estate subject to the estate tax lien has a fair market value that is at least double the amount of the unsatisfied liability secured by the estate tax lien (§6325(b)(1));
- An "adequate amount" (not less that the value of the interest in the property being discharged) has been paid in partial satisfaction of the estate tax liability (§6325(b)(2)(A));
- The property subject to the lien has no value (§6325(b)(2)(B));
- Funds held in escrow may be released in the officer's discretion for paying allowable expenses of administering the estate or when the officer later determines that the estate tax liability is adequately provide for or after verification that all assessment (tax, interest and penalty) have been made (IRM 5.5.2.6, & 5.12.10.3.4); and
- The owner deposits an amount equal to the value of the IRS's interest in the property or furnishes an acceptable bond (IRM 12.10.3.5).

The revised procedures are useful, but problems will remain. Estate often need the cash from property sales to pay expenses or debts, but the IRS wants all of the net sales proceeds even though plenty of assets remain to pay estate taxes. Collection officers are encouraged (and in the case of an estate that filed a Form 706 and paid its tax, the officer is *directed*) to contact the estate and gift tax group before making a decision. Collection officers typically are not familiar with estates or estate tax deductions or calculations, and the lack of familiarity will require coordination with the estate and gift tax group and will slow the approval process. Timing is a serious concern because real estate transactions are time-sensitive:

> The IRS's interim guidance is a "step in the right direction" but it's not a magic bullet in solving the issues that have been raised," [said Christine Wakeman (Dallas, Texas)].
>
> …
>
> "So we've got people who know nothing about estate planning processing this form, and they've now told then that, "Yes, a discharge may very well be appropriate in this situation," but it's also telling them to refer to Examination Estate & Gift if they're unsure, Wakeman said. At least at the beginning, those officials will likely need to consult the estate and gift tax specialists every time because they don't have a working familiarity with those issues, she said.
>
> This eats up time and "in the meantime, we've got a real estate contract and if it doesn't close in 60 days, the seller's in default," Wakeman said.
>
> Versprille, *Estate Tax Lien Guidelines Useful, but May Not Solve Problems*, BNA DAILY TAX REPORT (April 14, 2017).

Planning Tip: For older clients who anticipate that real estate will be sold after their deaths to pay administration expenses or state taxes, consider contributing the real estate into a single member LLC prior to death. The estate tax lien applies to the membership interest in the LLC, not to the underlying real estate.

27. Scathing Rejection of Application of Subtance Over Form Doctrine, *Summa Holdings, Inc. v. Commissioner*.

The Sixth Circuit court of appeals refused to apply the substance over form doctrine, using very strong language repudiating the IRS's attempt to recharacterize corporate dividends to a Roth IRA as dividend payments to the shareholders followed by contributions by the shareholders to their Roth IRAs (far in excess of contribution limits). *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (Feb. 16, 2017). Taxpayers funded their Roth IRAs within contribution limits, and an initial stock investment by the Roth IRA of $1,500 grew to over $ 3 million within eight years. The rather complicated fact situation involved Roth IRAs that owned shares in a C corporation that in turn owned a domestic international sales corporation (DISC). The net effect of the DISC arrangement is to "transfer export revenue to the export company's shareholders as a dividend without taxing it first as corporate income." When the dividend is paid to the Roth IRA, it does not have to treat the dividend as income (a regular IRA would have to treat the dividend as unrelated business taxable income). The IRS treated this as an abusive scheme to accumulate massive amounts in the Roth IRA, far in excess of the permitted contribution limits that an individual could contribute to the Roth IRA. The Tax Court agreed and applied the substance over form doctrine to recharacterize the DISC commissions as dividends to the shareholders and then as regular contributions to Roth IRAS (far exceeding the contribution limits).

The Sixth Circuit disagreed, excoriating the IRS for not applying the normal rules applicable to DISCs and Roth IRAs. Excerpts of the court's opinion are quoted at length in light of the interesting scathing rejection of the IRS's application of the substance over form doctrine in this context.

> Caligula posted the tax laws in such fine print and so high that his subjects could not read them…. That's not a good idea, we can all agree. How can citizens comply with what they can't see? And how can anyone assess the tax collector's exercise of power in that setting? The Internal Revenue Code improves matters in one sense, as it is accessible to everyone with the time and patience to pour over its provisions.
>
> In today's case, however, the Commissioner of the Internal Revenue Service denied relief to a set of taxpayers who complied in full with the printed and accessible words of the tax laws…. He acknowledged that the family had complied with the relevant provisions. And he acknowledged that the purpose of the relevant provisions was to lower taxes. But he reasoned that the effect of these transactions was to evade the contribution limits on Roth IRAs and applied the "substance-over-form doctrine" … to recharacterize the transactions as dividends from Summa Holdings to the Benensons followed by excess Roth IRA contributions. The Tax Court upheld the Commissioner's determination.
>
> **Each word of the "substance-over-form doctrine," at least as the Commissioner has used it here, should give pause. If the government can undo transactions that the terms of the Code expressly authorize, it's fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is. "Form" *is* "substance" when it comes to law. The words of law (its form) determine content (it's substance). How odd, then, to permit the tax collector to reverse the sequence – to allow *him* to determine the substance of a law and to make it govern "over" the written form of the law – and to call it a "doctrine" no less.**
>
> As it turns out, the Commissioner does not have such sweeping authority. And neither do we. Because Summa Holdings used the DISC and Roth IRAs for their congressionally sanctioned purposes—tax

avoidance—the Commissioner had no basis for re-characterizing the transactions and no basis for me characterizing the law's application to them. We reverse.

…

… **It's one thing to permit the Commissioner to recharacterize the economic substance of a transaction—to honor the fiscal realities of what taxpayers have done over the form in which they have done it. But it's quite another to permit the Commissioner to recharacterize the meaning of statutes—to ignore their form, their words, in favor of his perception of their substance.**

As originally conceived and as traditionally used, the substance-over-form doctrine has something to it…. When the courts decide how to classify a transaction, they focus, quite appropriately, on the transaction's workaday realities, not the labels used by the taxpayers. Take "income." If a taxpayer receives something of value, 26 U.S.C. § 61(a), he can call it whatever he wants—this, that, or something else. What the taxpayer cannot do is claim that the label he affixes on the transaction precludes it from being "income" under the Code or prevents the courts from treating it as "income" under the Code.

…

But these economic-substance principles—which undergird the traditional use of the substance-over-form doctrine—do not give the Commissioner purchasing power here…. By congressional design, DISCs are all form and no substance, making it inappropriate to tag Summa Holdings with a substance-over-form complaint with respect to its use of DISCs.

The same is true for the Roth IRAs. They, too, are designed for tax-reduction purposes…. All IRAs are permitted to hold shares of stock, some of which may increase markedly in value over time and some of which may generate considerable dividends over time. Whether Congress's decision to permit Roth IRAs to our own DISCs was an oversight makes no difference. It's what the law allowed.

…

That leaves the Commissioner to invoke another, distinct version of the substance-over-form doctrine. **When two potential options for structuring a transaction lead to the same end and the taxpayers choose the lower-tax path, the Commissioner, claims the power to recharacterize the transactions as the higher-taxed equivalents. It's not that the transactions don't have economic substance (they do) or that the Code forbids them (it doesn't). Instead, the Commissioner simply stipulates that the "real" transaction is the higher-taxed one, and that the lower-taxed route, often the more complex of the two, is a mere "formality" he can freely disregard.** The Commissioner claims the right to assert this power against "any given transaction[,] based on [the] facts and circumstances" of the arrangement…. That is a much broader (and more worrisome) version of the doctrine.

…

As *Court Holding* suggests, the line between disregarding a too-clever-by-half accounting trick and nullifying a Code-supported tax-minimizing transaction can be elusive. Some cases from our court, fact specific though they are, offer hints of a broad reading of *Court Holding*, saying that the Commissioner may recharacterize transactions, even those with economic substance, if they have no "valid, non-tax business purpose." … Decisions from our sister courts also straddle the line between holding that the transactions were a sham and suggesting that the Commissioner has a broad power to recharacterize transactions that minimize taxes, **though none of them holds that a tax-avoidance motive alone may nullify an otherwise Code-compliant and substantive set of transactions.**

It's fine—indeed essential—to attend to economic realities in deciding whether one of these terms ["income," "reorganization," "debt," "contribution," or "dividend"] covers a transaction. But it's odd to reject a Code-compliant transaction in the service of general concerns about tax avoidance. **Before long, allegations of tax avoidance begin to look like efforts at text avoidance. What started as a tool to prevent taxpayers from placing labels on transactions to avoid tax consequences they don't like runs the risk of becoming a tool that allows the Commissioner to place labels on transactions to avoid textual consequences he doesn't like.**

…

When the Commissioner says that the transaction amounted in substance to a Roth IRA contribution, all he means is that the purpose of the transaction was to funnel money into the Roth IRAs without triggering the contribution limits. True enough. **But the substance-over-form doctrine does not authorize the Commissioner to undo a transaction just because taxpayers undertook it to reduce their tax bills.**

Note that this broad recharacterization power travels along a one-way street. To our knowledge the Commissioner has never use this power to reclassify the form of a taxpayer's Code-compliant transaction to *reduce* his tax liabilities in the service of broader purposes of the Code. But if this were a legitimate doctrine, why wouldn't it run in both directions? Many provisions of the Code owe their existence solely to tax-reducing purposes: to lower current taxes or to shelter income from taxes over time.

…

Even if we were willing to endorse the Commissioner's recharacterization power in its full flowering form—disregarding transactions based solely on an individual's tax-minimizing motive—he could not use it here. No court has used this power to override statutory provisions whose only function is to enable tax savings, as the Commissioner seeks to do in this instance…. The point of these entities [DISCs and Roth IRAs] *is* tax avoidance. The Commissioner cannot place ad hoc limits on them by invoking a statutory purpose (maximizing revenue) that has little relevance to the text-driven function of these portions of the Code (minimizing revenue).

…

The Commissioner adds that the "critical point" of his argument is that the tax benefits Summa Holdings has enjoyed were "unintended by both the Roth IRA and DISC provisions." … He may be right. And he may be right that permitting these DISC-Roth IRA arrangements amounts to dubious tax policy. **But the substance-over-form doctrine does not give the Commissioner a warrant to search through the Internal Revenue Code and correct whatever oversights Congress happens to make or redo any policy missteps the legislature happens to take.**

…

… The last thing the federal court should be doing is rewarding Congress's creation of an intricate and complicated Internal Revenue Code by closing gaps in taxation whenever that complexity creates them. (Emphasis added as indicated by bold-faced text).

28. Interesting Quotations

a. **Legislation.** "The concept of portability was simple. It could have been simple. But it is legislation; ergo it is not simple." — Howard Zaritsky

b. **Repeal Prediction.** "I've been making predictions about the estate tax for 40 years. So far I've been incorrect. So, I'm due. I think the estate tax will be repealed sometime in late 2017, but it will have a 10-year 'sunrise' – with the estate tax popping up again in 10 years." — Howard Zaritsky

c. **REAL Problems.** "If a client says 'my spouse will die first,' you may have bigger problems than tax planning."" — Howard Zaritsky

d. **Diversification.** An investment adage is "You get rich by over-concentration. You stay rich by diversification." — Howard Zaritsky

e. **Prince Charles Effect.** The "Prince Charles Effect" is that wealthy people live longer than the general population. The life expectancy statistics for wealthy people versus the general population are 91.9 vs. 81.2 years for females, and 88.8 vs. 76.4 years for males. — Richard Franklin and Lester Law

f. **Life Uncertainties.** The old Yiddish proverb is that "Man plans, God laughs." — Dennis Belcher

g. **Legislative Problems.** "Former Representative Bill Archer once told Stacy Eastland that when a member of Congress can cite a Code section by number, you know there is a problem." — John Porter

h. **Better or Worse?** The House Republican tax reform Blueprint for Tax Reform is entitled "a Better Way." "Of course, no one proposes 'the Worst Way'." — Ron Aucutt

i. **Uncertainty at the Diamond***.* The (now retired) baseball pitcher, Joaquín Andújar said ""You can sum up the game of baseball in one word: 'You never know.'" — John Porter (Another classic Andújar quote: "That's why I don't talk. Because I talk too much.")

j. **SPCA.** In discussing a recent case involving the Society for the Prevention of Cruelty to Animals, Prof. Sam Donald observed, "Just to be clear, the SPCA is taking the lawyer to the doghouse."— Sam Donaldson

k. **Every Man's Greatest Fear***.* Every man's greatest fear is that his surviving wife will massively upgrade to someone who will bring everything the first husband didn't – hair, a chiseled body that doesn't have to be covered by a sweater vest just to have the dignity to speak in public, someone who's handy around the house, someone who'll do things without having to be asked to help-because he wants to help and wants to participates and cares about co-responsibility. Perhaps I'm projecting." — Sam Donaldson

l. **Which of Those 1014(b) Subparagraphs Is It?** Section 1014(b)(9) is the sub-paragraph giving a basis adjustment for property in the gross estate. Prof. Sam Donaldson adds this memory device: "It is 1014(b)(9) – not "malignant," but "b-9." —Sam Donaldson

m. **The Doctor Is In.** The *Holliday v. Commissioner* case involved a decedent with one son who was a doctor. "We'll refer to him as Doc Holliday." —Sam Donaldson

n. **Tenth Circuit.** "The IRS did not appeal *Wandry*. The appeal would have been to the Tenth Circuit. The Tenth Circuit is based in Denver, and Colorado had just legalized marijuana. Treasury was not going to take a chance with what the judges there were going to say, particularly if oral argument wasn't scheduled until late afternoon." — Sam Donaldson

o. **Political Surprises***.* "We are in a time of tremendous political surprise. Paradigms have shifted, landmarks have been moved, all baselines are obsolete, and all predictions have been wrong." —Ron Aucutt

p. **Retroactive Tax Legislation***.* "If the estate tax is repealed retroactive to January 1, 2017, and if it is accompanied by carryover basis or realization at death, look out. Someone is bound to think of litigating that and some folks will just be dying to do it." —Ron Aucutt

q. **Tax Law Sunsets.** "Sunsets are pretty in Florida, they are ugly in D.C. Remember 2001 and 2010. That was chaos." —Ron Aucutt

r. **A Few Democrats.** Having some degree of bipartisanship in Congressional action is a good thing. "A few Democratic votes would be good cosmetics, but too many means giving up too much control of the product." —Ron Aucutt

s. **Tax Predictions.** "All predictions have been wrong." — Ron Aucutt

t. **From Simple to Complex.** "This thing has more layers to it than the typical episode of Desperate Housewives." — Sam Donaldson

u. **Fifth Circuit.** "The Clayton QTIP comes from the Fifth Circuit Court of Appeals, where etched on the courthouse steps it says 'Taxpayer Welcome.' You don't lose in the Fifth Circuit. As a taxpayer, there is a constitutional right to win in the Fifth Circuit. Guns and victory over the IRS are guaranteed in the Fifth Circuit."" —Sam Donaldson

v. **Surviving Spouse "Over-life."** "The credit shelter trust works better if the surviving spouse will live a long time, but a significant chunk of surviving 'spise' die within a year. For others, 'Cry Sweet Freedom Baby.' The remote is mine. I can delete Scandal and Gray's off the DVR. I can put up the mounted bass. I can live life to the fullest now – and live another 40 years."—Sam Donaldson

w. **Why Is It Called a Trust?** "Why is it called a trust? If I don't trust the surviving spouse, then I need a trust." — Sam Donaldson

x. **Memory Device for Remembering the 2017 Exemption Amount.** "The estate tax exemption is $5.49 million in 2017. I don't know why it couldn't have been an even $5.5 million. Instead we do Walmart pricing of it." — Sam Donaldson

y. **SNeAKY §2704 Proposed Regulations.** "I worry there is a snake in the grass in the section 2704(b) proposed regulations. The question is whether it's a garter snake or rattlesnake." —Dennis Belcher

z. **Too Late?** "The all-to-often client question ends with 'or am I too late.' Any time you have to ask that question, you probably already know the answer. You just want the doctor to tell you that you are dying instead of diagnosing yourself." — Sam Donaldson

aa. **Priorities.** Where is estate tax repeal in the order of priorities for tax reform? Sam Donaldson thinks fourth: "(1) Business reform-the signature feature –and reducing the corporate rates. (2) Slowing down the pace of tax audits. (3) Special provisions for individuals with net operating losses in excess of $900 million. (4) Somewhere below that is estate tax repeal." — Sam Donaldson

bb. **GRAT Animals.** "We have heard anecdotally of increased GRAT audits. GRATs have strict requirements. They are powerful animals, but if you don't care for and feed them properly, they can bite you." – Todd Angkatavanich

cc. **Creditor Protection in Texas.** "Texas was founded by debtors running away from creditors in the East, so it is a good place for debtors to live." —Stacy Eastland

dd. **Stretch Out IRAs.** "The kids want to know whether they can withdraw funds from the IRA on the way to the funeral or if they have to wait until after the funeral." —Mickey Davis

ee. **The Divorce Lawyer's View of Estate Planning.** "Take off your trust and estate hat when you venture into this divorce area. It is a different world. They think differently. The rules are different." Scott Rubin (family lawyer in Miami, Florida) adds that "in the family lawyer's world, a living trust is always revocable."

ff. **Engagement Letters.** Engagement letters should include "we don't guarantee results." —Bruce Stone gg. **Just Agree There Are No Taxes.** "Late in the evening at the end of protracted settlement discussions of fiduciary disputes, litigators will often say 'Let's just agree the tax will be …' or 'let's just agree there are no tax issues.' —Melissa Willms

hh. **Godzilla IRS.** In reviewing the executor's personal liability under the literal terms of 31 USC 3713, "it looks like the IRS is Godzilla, the estate is Tokyo, and too bad – everything is doomed." – Melissa Willms

ii. **Client Screening.** "A lawyer should be measured not by the quality of clients he has, but by the clients he has turned away." – Shawn Snyder (quoting her mentor as a young lawyer)

jj. **Live It Up.** In discussing when to begin receiving Social Security, Larry Frolik observes that cash flow at 66 may be more "valuable" than having additional cash at age 85, if travel or other experiences may no longer be possible at age 85 (i.e., if you can no longer go scuba diving). ("I frankly don't care if I'm the richest guy in the nursing home.") – Larry Frolik

kk. **Three-Year Rule for Sale by Charitable Donee**. Charities must file Form 8282 with the IRS if they dispose of illiquid gifts within three years of the donation. Turney Barry tells charitable clients not to dispose of assets within that three-year period. "You might think, cynically, my reason is that if you told the IRS they would view it as nefarious. No, I'm a taxpayer as you are, and I don't want to burden the government with unnecessary paperwork." – Turney Berry

ll. **Three Years**. "Three years is a long time. Smart people can go through college in three years. Not any of us, but smart people can go to college in three years." – Turney Berry

mm. **Charitable Receipt Horror Story.** In December, 2016, headlines were in the newspapers about a corporation that was denied a $64 million charitable deduction because it did not get a proper receipt from the charity. It did receive a receipt, but the receipt did not have the "no goods or services were provided" language. The entire $64 million charitable deduction was lost. The case is *15 West 17th Street LLC v. Commissioner*, 147 T.C. No. 19 (Dec. 22, 2016)**.** – Susan Abbott

nn. **Section 501(c)(4) Changed Gift Rule**. The 2015 PATH Act provided that gifts to §501(c)(4) organizations would not be taxable gifts (even though no income tax charitable deduction is allowed). The IRS had issued rulings in the 70s saying that contributions to those organizations were taxable gifts. "In effect, the IRS was saying 'no moron gives political contributions unless they expect something in return. What kind of country do you think we're dealing with?'" – Turney Berry

oo. **Think Ahead**. Asset protection is part of mainstream estate planning. "Regardless of what someone's estate protection plan involves, the planning should be placed on today's agenda – not tomorrow's agenda." – Gideon Rothschild

pp. **It's What You Don't Know**. "There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know." – Donald Rumsfeld (quoted by Stacy Singer) qq. **A Tax Reform Certainty**. Howard Zaritsky discussed the hurdles of estate tax repeal, including budget issues, but concluded that there is a "100% chance of some kind of change." – Howard Zaritsky

rr. **Meet With Client Every Three Years**. Things change in client's lives, and Stuart Baer recommends meeting with clients every 3 to 5 years to determine whether changes to the estate plan are appropriate. He sends a note to clients after three years saying "Come see me. It's a free meeting. I'll serve coffee." By the time they procrastinate, we're at the five year mark. – Stuart Bear

ss. **Testamentary Capacity Reflections**. "The standard for testament capacity is lower than the capacity standard for other transactions. To paraphrase George Carlin (and clean it up), the testamentary capacity standard is simply: 'I know my stuff and I understand who is to receive my stuff.' Why is the capacity standard lower for wills than for other documents? The lower standard is for a transfer that occurs after death, and it doesn't affect the person personally and their lifestyle. A power of attorney or health care directive affects the client during life." – Stuart Bear