Recent Developments

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RECENT DEVELOPMENTS[1]

LEGISLATIVE AND REGULATORY DEVELOPMENTS

1. Revenue Procedure 2018-57 (November 15, 2018)

IRS announces inflation adjustments for 2019

The following are some of the inflation adjustments for 2019.

1. Tax Rate Tables

TABLE 1 – Married Individuals Filing Joint Returns and Surviving Spouses

If Taxable Income is:	The Tax is:
Not over $19,400	10% of the taxable income
Over $19,400 but not over $78,950	$1,940 plus 12% of the excess over $19,400
Over $78,950 but not over $168,400	$9,086 plus 22% of the excess over $78,950
Over $168,400 but not over $321,450	$28,765 plus 24% of the excess over $168,400
Over $321,450 but not over $408,200	$65,497 plus 32% of the excess over $321,450
Over $408,200 but not over $612,350	$93,257 plus 35% of the excess over $408,200
Over $612,350	$164,709.50 plus 37% of The excess over $612,350

[1] These materials are based on materials prepared by Ronald D. Aucutt, Kevin G. Bender, Andrea Chomakos, W. Birch Douglas, III, Charles D. Fox IV, Meghan Gehr Hubbard, Sean Murphy, Stephen W. Murphy, and William I. Sanderson of McGuireWoods LLP.

TABLE 2 – Heads of Household

If Taxable Income is:	The Tax is:
Not over $13,850	10% of the taxable income
Over $13,850 but not over $52,850	$1,385 plus 12% of the excess over $13,850
Over $52,850 but not over $84,200	$6,065 plus 22% of the excess over $52,850
Over $84,200 but not over $160,700	$12,962 plus 24% of the excess over $84,200
Over $160,700 but not over $204,100	$31,322 plus 32% of the excess over $160,700
Over $204,100 but not over $510,300	$45,210 plus 35% of the excess over $204, 100
Over $510,300	$152,380 plus 37% of the excess over $510,300

TABLE 3 – Unmarried Individuals (other than Surviving Spouses and Heads of Household)

If Taxable Income is:	The Tax is:
Not over $9,700	10% of the taxable income
Over $9,700 but not over $39,475	$970 plus 12% of the excess over $9,700
Over $39,475 but not over $84,200	$4,543 plus 22% of the excess over $39,475
Over $84,200 but not over $160,725	$14,382.50 plus 24% of the excess over $84,200
Over $160,725 but not over $204,100	$32,748.50 plus 32% of the excess over $160,725
Over $204,100 but not over $510,300	$46,628.50 plus 35% of the excess over $204, 100

Over $510,300	$153,798.50 plus 37% of the excess over $510,300

TABLE 4 – Married Individuals Filing Separate Returns

If Taxable Income is:	The Tax is:
Not over $9,700	10% of the taxable income
Over $9,700 but not over $39,475	$970 plus 12% of the excess over $9,700
Over $39,475 but not over $84,200	$4,543 plus 22% of the excess over $39,475
Over $84,200 but not over $160,725	$14,382.50 plus 24% of the excess over $84,200
Over $160,725 but not over $204,100	$32,748.50 plus 32% of the excess over $160,725
Over $204,100 but not over $306,175	$46,628.50 plus 35% of the excess over $204,100
Over $306,175	$82,354.75 plus 37% of the excess over $306,175

TABLE 5 – Estates and Trusts

If Taxable Income is:	The Tax is:
Not over $2,600	10% of the taxable income
Over $2,600 but not over $9,300	$260 plus 24% of the excess over $2,600
Over $9,300 but not over $12,750	$1,868 plus 35% of the excess over $9,300
Over $12,750	$3,075.50 plus 37% of the excess over $12,750

2. Standard Deductions

For taxable years beginning in 2019, the standard deduction amounts under Section 63(c)(2) are as follows:

Filing Status	Standard Deduction
Married Individuals Filing Joint Returns and Surviving Spouses	$24,400
Heads of Households	$18,350
Unmarried Individuals (other Than Surviving Spouses and Heads of Households)	$12,200
Married Individuals Filing Separate Returns	$12,200

3. Qualified Business Income Under Section 199A

For taxable years beginning in 2019, the threshold amount under Section 199(e)(2) is $321,400 for married filing joint returns, $160,725 for married filing separate returns, and $160,700 for single and head of household returns.

4. Basic Exclusion Amount

For an estate of any decedent dying in calendar year 2019, the basic exclusion amount is $11,400,000 for determining the amount of the unified credit against estate tax under Section 2010. The unified credit is $4,505,800.

5. Annual Exclusion for Gifts

(1) For calendar year 2019, the first $15,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gifts under Section 2503 made during that year.

(2) For calendar year 2019, the first $155,000 of gifts to a spouse who is not a citizen of the United States (other than gifts of future interests in property) are not included in the total amount of taxable gifts under Section 2503 and 2523(i)(2) made during that year.

6. Interest on a Certain Portion of the Estate Tax Payable in Installments.

For an estate of a decedent dying in calendar year 2019, the dollar amount used to determine the "2-percent portion" (for purposes of calculating interest under Section 6601(j)) of the estate tax extended as provided in Section 6166 is $1,550,000.

2. 2018-2019 Priority Guidance Plan (November 8, 2018)

Treasury Department and Internal Revenue Service release their 2018-2019 Priority Guidance Plan

On November 8, 2018, the Treasury Department and the Internal Revenue Service released their 2018-2019 Priority Guidance Plan which lists those projects which will be the focus of the IRS's efforts during the twelve-month period from July 1, 2018 through June 30, 2019. The 2018-2019 Priority Guidance Plan contains 239 guidance projects of which guidance on 45 items had been released as of October 31, 2018. Each item listed below is identified by the number given in the different parts of the Priority Guidance Plan.

Part 1 of the Plan is titled "Implementation of Tax Cuts and Jobs Act (TCJA)." The estate and gift tax and related items in Part 1 are:

3. Guidance clarifying the deductibility of certain expenses described in Section 67(b) and (e) that are incurred by estates and non-grantor trusts. This guidance was published as Notice 2018-61 in 2018-31 I.R.B (released July 13, 2018).

13. Final regulations on computational, definitional, and anti-avoidance rules under new Sections 199A and 643(f). Proposed regulations on computational, definitional, and anti-avoidance guidance under new Sections 199A and 643(f) were released on August 8, 2018.

14. Revenue procedure on methods for calculating W-2 wages for purposes of new Section 199A. A notice of a proposed revenue procedure on this was released on August 8, 2018.

15. Regulations under Section 199A and other guidance for cooperatives and their patrons.

16. Guidance on methods for calculating W-2 wages for purposes of new Section 199A for cooperatives and their patrons.

37. Regulations under Section 2010 addressing the computation of the estate tax in the event of a difference between the basic exclusion amount applicable to gifts and that applicable at the donor's date of death. This will address any possible "claw back" concerns if the estate and gift tax exemption reverts to $5 million adjusted for inflation in 2026. Proposed Regulations on this were issued on November 20, 2018.

40. Regulations on the excise tax on the net investment income of certain private colleges and universities under new Section 4968.

Part 3. Burden Reduction. This part contains the following items dealing with estate and gift tax and related areas:

4. Final regulations under Sections 1014(f) and 6035 regarding basis consistency between estates and persons acquiring property from a decedent. Proposed and temporary regulations were published on March 4, 2016.

8. Final regulations under Section 2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption.

9. Final regulations streamlining the Section 754 election statement. Proposed regulations were published on October 12, 2017.

11. Guidance under Treas. Reg. Section 301.9100 regarding relief for late regulatory elections.

Part 5. General Guidance. The section on gifts and estates and trusts in Part 5 includes the following items:

1. Guidance on the basis of grantor trust assets at death under Section 1014.

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

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

4. Regulations under Section 7520 regarding the use of actuarial tables in valuing annuities, interest for life or terms of years, and remainder or reversionary interests.

The first three items were carried over from the 2017-2018 priority guidance plan. The fourth item is new.

3. Proposed Treasury Regulation § 20.2010-1(c) (November 20, 2018)

Treasury Department issues proposed anti-clawback regulations

Proposed Regulations (REG-106706-18) were released on November 20, 2018, and published in the Federal Register on November 23, 2018 (83 Fed. Treas. Reg. 59343), to prevent the "clawback" of the benefits of the doubled federal gift tax exemption during 2018 through 2025 if the "sunset" of those benefits occurs in 2026 as currently scheduled and the donor dies in 2026 or later. Although neither the statute nor the proposed regulations use the word "clawback," the regulations would carry out the mandate of the 2017 Tax Act in new Section 2001(g)(2), which provides that Treasury "shall prescribe such regulations as may be necessary or appropriate to carry out this

Section with respect to any difference between (A) the basic exclusion amount under Section 2010(c)(3) applicable at the time of the decedent's death, and (B) the basic exclusion amount under such Section applicable with respect to any gifts made by the decedent."

The proposed regulations would add a new paragraph (c) to Treas. Reg. § 20.2010-1 (with the current paragraphs (c) through (e) redesignated as (d) through (f)), providing that if the total of the unified credits attributable to the basic exclusion amount that are taken into account in computing the gift tax payable on any post-1976 gift is greater than the unified credit attributable to the basic exclusion amount that is allowable in computing the estate tax on the donor's estate, then the amount of the credit attributable to the basic exclusion amount that is allowable in computing that estate tax is not determined under Section 2010(c) but is deemed to be that greater total of gift tax unified credits attributable to the basic exclusion amount.

Example. Proposed Treas. Reg. § 20.2010-1(c)(2) provides the following Example:

"Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $10 million in basic exclusion amount allowable on the dates of the gifts. A dies after 2025 and the basic exclusion amount on A's date of death is $5 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million basic exclusion amount used to determine those credits) exceeds the credit based on the $5 million basic exclusion amount applicable on the decedent's date of death, under paragraph (c)(1) of this Section, the credit to be applied for purposes of computing the estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on the post-1976 gifts made by A."

Viewed another way, if what would otherwise be the basic exclusion amount for estate tax purposes is less than the total of the basic exclusion amount applied to post-1976 taxable gifts, it is increased for estate tax purposes under this new regulation to equal that total. And if, in the example, the gift had been $12 million instead of $9 million, then the entire assumed $10 million basic exclusion amount would be used with still some gift tax payable (the donor having never married), and the estate tax credit would be computed as if the basic exclusion amount were $10 million.

Under Proposed Treas. Reg. § 20.2010-1(f)(2), the anti-clawback rule would take effect when it is adopted as a final regulation.

Contemporaneously with the release of the proposed regulations, the IRS issued a news release with the reassuring headline of "Treasury, IRS: Making large gifts now won't harm estates after 2025." The press release includes an even simpler explanation that "the proposed regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the BEA [basic exclusion amount] applicable to gifts made during life or the BEA applicable on the date of death."

In their practical effect, the proposed regulations do what the statute asks – nothing more, nothing less. The statute compares a transfer at death after 2025 (subparagraph (A)) with a transfer by gift before 2026 (subparagraph (B)). And this is what the proposed regulation would address. For example, the proposed regulation would not address the similar scenario of gifts both before 2026 and after 2025. If large amounts of the increased credit attributable to the new doubled basic exclusion amount are used to shelter gifts from gift tax before 2026 (like the $9 million gift in the Example), then after 2025 the donor might have to wait for decades for the indexed $5 amount to catch up so there can be more credit available for gift tax purposes.

Likewise, the text of the regulation and the Example (and the description above in this Alert) are painstakingly limited in all cases to the amount of the credit that is attributable to the basic exclusion amount – that is, the amount (indexed since 2012) defined in Section 2010(c)(3). Regarding portability, for example, that approach makes it clear that the deceased spousal unused exclusion amount (DSUE amount) defined in Section 2010(c)(4) is not affected by this special rule and is still added under Section 2010(c)(2)(B), in effect thereby generating an additional credit of its own in cases in which the anti-clawback rule applies. But it still may be that the words "lesser of" in Section 2010(c)(4) will limit the DSUE amount available to the estate of a person who dies after 2025 (assuming no change in the law) to the sunsetted basic exclusion amount of $5,000,000 indexed for inflation in effect at the time of the death of the surviving spouse referred to in Section 2010(c)(4)(A), despite the assertion in Treas. Reg. § 20.2010-2(c)(1) that "the DSUE amount of a decedent with a surviving spouse is the lesser of the following amounts – (i) The basic exclusion amount in effect in the year of the death of the decedent" (presumably the predeceased decedent), and despite the statement in the preamble to the June 2012 temporary regulations that "[t]he temporary regulations in Treas. Reg. § 20.2010-2T(c)(1)(i) confirm that the term 'basic exclusion amount' referred to in Section 2010(c)(4)(A) means the basic exclusion amount in effect in the year of the death of the decedent whose DSUE amount is being computed." That limitation gives effect to the general notion held by congressional drafters that portability should, in effect, be allowed to no more than double what would otherwise be the survivor's exemption.

But if the proposed regulations follow the statute very closely as to their practical effect, it is harder to say that they follow the context of the statute as to their approach and form. Before the proposed regulations were released, there was speculation that the regulations under Section 2001(g)(2) would mirror Section 2001(g)(1) with which their statutory authority is linked and provide, in effect, that in calculating the estate tax the basic exclusion amount in effect at the time of death will be used to calculate the hypothetical "total gift tax paid or payable" on pre-2026 adjusted taxable gifts that is deducted under Section 2001(b)(2) on line 7 of Part 2 of the estate tax return. And by increasing the amount on line 7, which is subtracted in line 8, the estate tax would be appropriately reduced to offset the clawback effect.

But the proposed regulations take a different approach. The preamble implies that other approaches were considered, but concludes that "in the view of the Treasury Department and the IRS, the most administrable solution would be to adjust the amount of the credit in Step 4 of the estate tax determination required to be applied against the net tentative estate tax." In the context of the new regulation, "Step 4" in the preamble apparently most closely corresponds to line 9a of Part 2 of the estate tax return ("basic exclusion amount"); Step 2 corresponds to line 7.

By increasing the amount on line 9a, rather than the amount on line 7, the proposed regulations would achieve the same result, of course, because both line 7 and lines 9a through 9e produce subtractions in the estate tax calculation. But line 7 already requires three pages of instructions, including a 24-line worksheet, to complete, and an incremental increase of complexity in what already has a reputation for being a tangled morass might be easier to process than adding a new challenge to line 9, which now requires less than one-third of a page of instructions. But, needless to say, IRS personnel see more returns than we do, they see the mistakes, and they hear the complaints. Presumably – hopefully – they contributed to forming the assessment that the line 9 approach is "the most administrable solution."

That approach should work fine if the law is not changed and sunset occurs January 1, 2026. But, although the example in Proposed Treas. Reg. § 20.2010-1(c)(2) mentions that the donor "dies after 2025," the substantive rule in Proposed Treas. Reg. § 20.2010-1(c) applies by its terms whenever "changes in the basic exclusion amount … occur between the date of a donor's gift and the date of the donor's death." It is not limited to 2026 or to any other particular time period. The 2010 statutory rule in Section 2001(g)(1) and the 2017 statutory rule in Section 2001(g)(2) are not limited to any time period either. Therefore, if Congress makes other changes in the law, particularly increases in rates or decreases in exemptions, and doesn't focus on the potential clawback issue in the context of those changes, the generic anti-clawback regime of Section 2001(g)(1) and (2) and these regulations could produce a jigsaw puzzle of adjustments going different directions that may strain the notion of administrability cited in the preamble.

The Example in Proposed Treas. Reg. § 20.2010-1(c)(2) is generally helpful, mainly because it is simpler and more readable than the rule in Proposed Treas. Reg. § 20.2010-1(c)(1) itself. But, perhaps to help achieve that simplification, the drafters of the example used unindexed basic exclusion amounts of $10 million before 2026 and $5 million after 2025, thereby rendering it an example that could never occur under current law, and possibly causing concern that the proposed anti-clawback rule would apply only to the unindexed basic exclusion amount. Because the inflation adjustment is an integral part of the definition of "basic exclusion amount" in Section 2010(c)(3), there should be no question that it is the indexed amount that is contemplated and addressed by the regulation, despite the potential implication of the example.

In any event, the final regulations could benefit from more examples than just one, showing how the outcome would adapt to changes in the assumptions, including examples with indexed numbers, examples with numbers below $5 million (indexed) and above $10 million (indexed), examples with portability elections, and examples with allocations of GST exemption.

There had also been speculation that the regulations might address the option of making, for example, a $5 million gift during the 2018-2025 period (assuming no previous taxable gifts) and treating that gift as using only the temporary "bonus" exclusion resulting from the 2017 Tax Act, which is sometimes described as using the exclusion "off the top," still leaving the exclusion of $5 million (indexed) to generate a credit to be used against the estate tax after 2025. But that type of relief would go beyond the objective of preserving the benefits of a 2018-2025 use of the increase in the basic exclusion amount and would, in effect, extend the availability of those benefits beyond

2025. Although the preamble to the proposed regulations does not refer directly to that issue, it appears that it would require a different regulatory analysis to achieve that result.

The Notice of Proposed Rulemaking asked for comments from the public by February 21, 2019, and announces a public hearing to be held, if requested, on March 13, 2019.

4. IRS Issues Final Regulations on Section 199A (January 18, 2019)

IRS proposes final regulations on passthrough deduction under new Section 199A

On January 18, 2019, the Internal Revenue Service (IRS) and the Department of the Treasury released regulations on new Section 199A, the 20 percent deduction for qualified business income, added to the Internal Revenue Code by the 2017 Tax Act. A revised version of the final regulations was issued on February 1, 2019 to make some corrections in the January 18th version of the final regulations.

Revenue Procedure 2019-11 was also issued on January 18, 2019. This revenue procedure provides methods for calculating W-2 wages for purposes of Section 199A. Notice 2019-07 was issued as well on January 18, 2019. This notice contains a proposed revenue procedure to provide a safe harbor permitting a rental real estate enterprise to be treated as a trade or business under Section 199A. Finally, proposed regulations were issued to address matters not addressed in either the August 8th proposed regulations or the January 18th final regulations.

While the proposed regulations issued on August 8, 2018 provided guidance to taxpayers and practitioners on significant issues that arose with the enactment of the new 20 percent deduction, they left many significant issues unaddressed, many of which have been addressed in the final regulations.

The final regulations under Section 199A provide definitional, computational, and anti-avoidance guidance helpful in determining the appropriate deductible amount. Additionally, the IRS and Treasury proposed regulations under Section 643(f) that contain anti-avoidance provisions with respect to the use of multiple nongrantor trusts to circumvent the purpose of Section 199A. The Section 199A proposed regulations contain six sections, each briefly summarized below.

Background

Section 199A provides generally that taxpayers other than corporations may claim a deduction for 20 percent of their qualified business income from a partnership, S corporation, or sole proprietorship. These passthrough entities are referred to as “Relevant Passthrough Entities” (RPEs). “Qualified business income” for purposes of Section 199A is defined generally as the net amount of income, gain, deduction, and loss with respect to the qualified trade or business, excluding certain investment-related income and guaranteed payments to partners in a partnership. A “qualified trade or business” is defined generally as any trade or business except the trade or business of performing services as an employee and any specified service trade or business (SSTB).

The deduction under Section 199A is limited generally to the greater of: (1) 50 percent of the W-2 wages of the trade or business for the taxable year, or (2) the sum of 25 percent of such wages and 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property for the taxable year (referred to awkwardly in the regulations as "UBIA of qualified property"). The W-2 wage and UBIA of qualified property limitations do not apply to taxpayers with a taxable income of less than $157,500 ($315,000 for married couples filing jointly) adjusted for inflation and is phased in for taxpayers with taxable income above that threshold amount. The thresholds for 2019 are $160,700 for single taxpayers and heads of household, $160,725 for married taxpayers filing separately, and $321,400 for married taxpayers filing joint returns. Finally, the Section 199A deduction cannot exceed the taxpayer's taxable income over net capital gain for the tax year.

Operational Rules

The first Section of the regulations under Section 199A provides guidance on the determination of the Section 199A deduction generally. The regulations clarify that, for purposes of Section 199A, the term "trade or business" should be interpreted in a manner consistent with the guidance under Section 162, which provides a deduction for ordinary and necessary business expenses. The regulations under Section 199A, however, expand the traditional definition under Section 162 to include certain rental or licensing of property to related parties under common control.

This first Section also provides guidance on computing the deduction for a taxpayer that has taxable income above, at, or below the threshold amount for applying the W-2 wage and UBIA of qualified property limitations. In doing so, the IRS and Treasury prescribe computational rules, including rules for determining carryover losses and for the treatment of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income.

Finally, the first Section of the regulations provides that the Section 199A deduction is applied at the partner or shareholder level. The deduction does not affect the adjusted basis of a partner's interest in a partnership, the adjusted basis of a shareholder's stock in an S corporation, or an S corporation's accumulated adjustments account.

Determination of W-2 Wages and the UBIA of Qualified Property

The second section of the regulations prescribes rules for determining W-2 wages and the UBIA of qualified property. The regulations provide that W-2 wages of a qualified trade or business are determined generally using the rules that applied under former Section 199 with respect to the domestic production activities deduction. The IRS and Treasury state in the preamble of the proposed Section 199A regulations that Notice 2018-64, issued concurrently with the regulations, provides three methods for calculating the W-2 wages of a qualified trade or business.

Additionally, the second section of the regulations addresses many issues concerning the UBIA of qualified property, including its allocation among relevant passthrough entities, subsequent improvements to the qualified property, and the effect of certain nonrecognition transactions (for example, like-kind exchanges). The regulations put in place guardrails to prevent taxpayers from gaming the system. For example, the regulations indicate that property is not qualified property if a taxpayer acquires and disposes of the property in a short period unless the taxpayer demonstrates

that the principal purpose of the acquisition and disposition was not to increase the Section 199A deduction.

Qualified REIT Dividends and Qualified Publicly Traded Partnership Income

The third section of the regulations restates the definition of qualified business income (QBI) and provides additional guidance on the determination of QBI, qualified REIT dividends, and qualified PTP income. The regulations describe in further detail the exclusions from QBI, including capital gains, interest income, reasonable compensation, and guaranteed payments. With respect to qualified REIT dividends, the regulations contain an anti-abuse rule to prevent dividend-stripping and similar transactions aimed at increasing the qualified REIT dividends without having a corresponding economic exposure.

Aggregation Rules

The fourth section of the regulations addresses rules for aggregating multiple trades or businesses for the purposes of applying the computational rules of Section 199A. Commentators urged the IRS to apply the grouping rules for determining passive activity loss and credit limitation rules under Section 469. The IRS concluded that the rules under Section 469 were inappropriate for purposes of Section 199A, but did agree with commentators that aggregation should be permitted.

The regulations create a four-part test for aggregation. First, each trade or business a taxpayer proposes to aggregate must itself be a trade or business as defined by the regulations. Second, the same person, or group of persons, must own, directly or indirectly, a majority interest in each of the businesses for the majority of the taxable year. The regulations provide rules allowing for family attribution for this purpose. Third, none of the trades or businesses can be an SSTB. Finally, the trade or business must meet at least two of the three following characteristics:

(1) The businesses provide products and services that are the same or typically provided together.

(2) The businesses share facilities or significant centralized elements.

(3) The businesses are operated in coordination with each other.

Under the regulations, an individual taxpayer may aggregate trades or businesses operated through multiple passthrough entities; however, the taxpayer must determine the QBI, W-2 wages, and UBIA of qualified property for each trade or business separately before applying the aggregation rules. The regulations also permit a RPE to aggregate separate businesses that are operated either directly or through lower-tier RPEs.

Specified Service Trade or Business and the Trade or Business of Performing Services as an Employee

The fifth section of the regulations contains substantial guidance on the definition of an SSTB. Under Section 199A, if a trade or business is an SSTB, none of its items are taken into account for determining a taxpayer's QBI. A taxpayer who owns an SSTB conducted through an entity, such as an S corporation or partnership, is treated as engaged in an SSTB for purposes of Section 199A, regardless of the taxpayer's actual level of participation in the trade or business.

Notwithstanding the general rule, taxpayers with taxable income of less than $157,500 ($315,000 for married couples filing jointly) as adjusted for inflation may claim a deduction under Section 199A for QBI received from an SSTB. The Section 199A deduction phases out for taxpayers with taxable incomes over this threshold amount. If a trade or business is conducted by a passthrough entity, the phase-out threshold is determined at the individual, trust, or estate level, not at the level of the passthrough entity. Accordingly, a passthrough entity conducting an SSTB could have taxable income below the threshold amount but have no owners eligible for a Section 199A deduction because each of them has taxable income above the threshold amount (plus $50,000 or $100,000 in the case of a married couple filing jointly).

The regulations also attempt to combat what commentators have called the "crack and pack" strategy. Under this strategy, a business that would otherwise be an SSTB separates all its administrative functions into a separate entity to qualify that separate entity for the Section 199A deduction. To minimize the potential for this abuse, the regulations provide that an SSTB includes any trade or business with 50 percent or more common ownership. The final regulations deleted the 80 percent requirement (that the SSTB with 50 percent of more common ownership also provide 80 percent or more of its property or services to SSTB). The Service agreed with commentators that this require was unnecessary.

The regulations contain a lengthy and detailed definition of an SSTB. Generally, the regulations state that the existing guidance defining a "qualified personal service corporation" under Sections 448 and 1202 informs the definition of an SSTB under Section 199A. Pursuant to Section 199A(d)(2)(A), which incorporates the rules of Section 1202(e)(3)(A), an SSTB is any trade or business in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing, investment management, or trading or dealing in securities, or any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners. The regulations limit "reputation or skill" to trades or businesses involving the receipt of income for endorsing products or services, licensing or receiving income for the use of an individual's publicity rights, or receiving appearance fees.

The Service deleted the Business Incidental to an SSTB Test from the final regulations. As a result, the common control of an SSTB and a non SSTB will not causes to non SSTB to be treated as part of the SSTB. This differs from the situation in which an SSTB and a non SSTB are part of the same business

The common law and statutory rules used to determine whether an individual is an employee for federal employment tax purposes apply to determining whether an individual is engaged in the trade or business of performing services as an employee for purposes of Section 199A. The regulations also create a presumption that an individual who was treated as an employee for federal income tax purposes but is subsequently treated as other than an employee with respect to the same services is still engaged in the trade or business of performing services as an employee for purposes of Section 199A. The presumption attempts to prevent taxpayers from reclassifying employees as independent contractors in order to claim a Section 199A deduction.

Special Rules for Passthrough Entities, Publicly Traded Partnerships, Trusts, and Estates

The sixth section of the regulations contains special rules for passthrough entities, PTPs, nongrantor trusts, and estates. Passthrough entities, including S corporations and entities taxable

as partnerships for federal income tax purposes, cannot claim a deduction under Section 199A. Any passthrough entity conducting a trade or business, along with any PTP conducting a trade or business, must report all relevant information — including QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income — to its owners so they may determine the amount of their respective Section 199A deductions.

The regulations require that a nongrantor trust or estate conducting a trade or business allocate QBI, expenses properly allocable to the trade or business, W-2 wages, and UBIA of qualified property among the trust or estate and its beneficiaries. The allocation is based on the ratio that the distributable net income (DNI) distributed or deemed distributed to each beneficiary bears to the trust's or estate's total DNI for the taxable year. Any DNI not distributed is allocated to the nongrantor trust or estate itself. UBIA of qualified property is allocated without taking into account how depreciation deductions are allocated among the beneficiaries under Section 643(c). When calculating the threshold amount for purposes of applying the W-2 wage and UBIA limitations, unlike the proposed regulations, the final regulations provide that taxable income is computed at the trust or estate level taking into account any distributions of DNI.

For purposes of the Section 199A regulations, a qualified subchapter S trust (QSST) is treated as a grantor trust. The individual treated as the owner of the QSST is treated as having received QBI directly from the trade or business and not through the QSST.

The final regulations treat the S and non-S portions of an Electing Small Business Trust (ESBT) as a single trust when determining the threshold amount for the ESBT.

Anti-avoidance Guidance for Multiple Nongrantor Trusts

In addition to finalizing regulations under Section 199A, the IRS and Treasury finalized regulations under Section 643(f) designed to prevent taxpayers from manipulating the Section 199A deduction using multiple nongrantor trusts. Section 643(f) allows Treasury to prescribe regulations to prevent taxpayers from establishing multiple nongrantor trusts to avoid federal income tax. The regulations under Section 643(f) provide that when two or more trusts have the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and a purpose of such trusts is to avoid federal income tax, all of such trusts will be treated as a single trust for federal income tax purposes. Absent this anti-abuse rule, taxpayers could own a trade or business through multiple nongrantor trusts such that each trust would have taxable income below the threshold amount for applying the W-2 wage and UBIA limitations on the Section 199A deduction.

5. **Notice 2018-54, 2018-24 IRB 750 (May 23, 2018)**

IRS provides guidance on certain payments made in exchange for state and local tax credits

The purpose of this notice is to inform taxpayers that the Treasury Department and the IRS intend to propose regulations addressing the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive a credit against their state and local taxes.

The 2017 Tax Act limited an individual taxpayer's deduction for the aggregate amount of state and local taxes paid during the calendar year to $10,000. State and local tax payments in excess of those amounts are not deductible. This new limitation applies to taxable years from 2018 through 2025. In response to this new limitation, some state legislatures are considering or have adopted proposals that would allow taxpayers the make transfers to funds controlled by state or local governments or other specified transfers in exchange for credits against the state or local taxes that the taxpayer is required to pay. The aim of the proposals is to allow taxpayers to characterize such transfers as fully deductible charitable contributions for federal income tax purposes while using the same transfers to satisfy state or local tax liabilities.

The notice warns taxpayers that despite these state efforts to circumvent the new $10,000 limitation on the deduction of state and local taxes, they should be mindful that federal law controls the proper characterization of payments for federal income tax purposes. Proposed regulations will be issued to make it clear that the requirements of the Internal Revenue Code, informed by substance over form principles, will govern the federal income tax treatment of such transfers.

6. Press Release: Treasury Issues Proposed Rule on Charitable Contributions and State and Local Tax Credits (August 23, 2018)

Department of Treasury issues proposed rule on federal income tax treatment of payments and property transfers under state and local tax credit programs

The Treasury Department released this proposed rule to prevent charitable contributions from being used to circumvent the new limitation on state and local taxation under the 2017 Tax Act. The 2017 Tax Act limited the amount of state and local taxes that an individual could deduct to $10,000 per year. Several states have enacted or are considering tax credit programs to "circumvent" the $10,000 limit of the 2017 Tax Act.

The Treasury Department stated that the proposed rule is a straightforward application of a long-standing principal of tax law: when a taxpayer receives a valuable benefit in return for a donation to charity, the taxpayer can deduct only the net value of the donation of a charitable contribution. The rule applies that quid pro quo principle to state tax benefits provided to the donor in return for contributions.

The press release gives the following example: if a state grants a 50 percent credit and the taxpayer contributes $1,000, the allowable charitable contribution may not exceed $500. The proposed rule provides an exception for dollar-for-dollar state and local tax deductions and tax credits of no more than 15 percent of the payment amount of the fair market value of the property transferred. These guidelines will apply to both new and existing tax credit programs.

The press release also noted that because of the increase in the standard deduction of the 2017 Tax Act the Treasury Department projects that 90 percent of taxpayers will not itemize under the new tax law. It also estimates that approximately 5 percent of taxpayers will itemize and have state and local income tax deductions above the $10,000 cap. The Treasury Department also expects that only about 1 percent of taxpayers will see an effect on the tax benefits for donations to school choice tax credit programs.

7. Letter Rulings on Extension of Time to Make Portability Election

Extension of time to make portability election permitted

Numerous letter rulings (too numerous to list) have been, and continue to be, issued on the same fact pattern. Decedent's estate was less than the applicable exclusion amount in the year of decedent's death. Decedent's estate failed to file a federal estate tax return to make the portability election and discovered its failure to elect portability after the due date for making the election. In each letter ruling, the IRS determined that the requirements of Treas. Reg. § 301.9100-3 for granting an extension of time to make an election were met. Under this regulation, an extension of time will be granted if a taxpayer is deemed to have acted reasonably and in good faith. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer if the tax professional failed to make or advise the taxpayer to make the election. In 2018, the standard fee for a letter ruling requiring an extension of time under Treas. Reg. § 301.9100-3 is $10,000. Revenue Procedure 2018-1, 2018-1 IRB 1.

MARITAL DEDUCTION

8. Letter Ruling 201751005 (Issued September 18, 2017; Released December 22, 2017)

IRS grants extension of time to make QTIP election

The decedent, upon his death, provided that his estate would be divided into a bypass trust, a marital trust, and a survivor's trust. The marital trust qualified for the QTIP marital deduction. The executor of the decedent's estate was a CPA. The executor's accounting firm prepared the Form 706 for the decedent's estate. However, the executor misinterpreted the terms of the trust and failed to make the QTIP election with respect to the marital trust. The executor requested an extension of time under Treas. Reg. §§ 301.9100-1 and 301.9100-3 to make the QTIP election to treat the marital trust as QTIP property.

The IRS granted the request for an extension of time to make the QTIP marital deduction election. Treas. Reg. § 301.9100-3 provides that an extension of time will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make the election or failed to advise the taxpayer to make the election. One question not addressed in this letter ruling is that the executor was a CPA himself or herself and therefore might be considered a qualified tax professional, although his or her area of expertise may not have been estate, gift, and generation-skipping taxes.

GIFTS

9. **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)**

IRS attacks use of Wandry clause in gift and sale of interests in a family business

In the True v. Commissioner case, Husband gave interests in a family business to one of his daughters. At the same time, he sold interests in the family business to his three children and a trust. Husband obtained appraisals from FMV which the court noted is a recognized and reputable national appraisal firm. Since Husband and Wife split the gift, any gift was considered made one-half by each spouse.

When the gifts of the interests in the family business were made to the daughter, the transfer agreement provided that if the value of the interests transferred to the daughter were determined to be worth more than $34,044,838 for federal gift tax purposes, then the interests owned by the daughter would be adjusted so that the value of the gift remained at $34,044,838 and the daughter would be treated as having purchased the ownership interests that were removed from the gift. Thus, the transfer documents utilized adjustment provisions to fix the value of the interests given to the daughter at a specific dollar value similar to the adjustment clause upheld by the Tax Court in Wandry v. Commissioner, T.C. Memo 2012-88 and with which decision the Service disagrees.

With respect to the interests that were sold to that daughter and the other two children and a trust, the transfer documents provided that if the interests sold were undervalued by FMV for federal gift tax purposes, the purchase price would be increased to reflect the fair market value as finally determined for gift tax purposes.

The IRS has alleged a gift tax deficiency of $16,591,418 by each of Husband and Wife. Husband and Wife have countered that the valuations are correct. However, if the transferred interests are determined to have a higher value, no gift should result because of the adjustment provisions contained in the transfer agreement. These two cases may help determine the future validity and usefulness of Wandry adjustment clauses.

10. **Letter Ruling 201803003 (Issued October 6, 2017; Released January 9, 2018)**

Proposed trust modifications will not trigger gift or generation-skipping tax

An irrevocable trust was created prior to October 22, 1942 by parents for the benefit of Daughter. The Daughter's only right was to receive distributions of net earnings, but not principal, awarded to her by the trustee with the consent of the advisory board of the trust and to distribution of the trust estate made by the trustee at the termination of the trust. At Daughter's death, her equitable interest was to pass to and vest in her heirs in accordance with the laws of descent and distribution then in force. The trust was to continue for Daughter's life and for a period of 21 years after her death at which time the trust would terminate and the trust corpus would be distributed to the beneficiaries.

Because of a planned disclaimer, certain of the children and grandchildren of Daughter had sought a declaratory judgment concerning the impact of their planned disclaimers. The court ruled that Daughter and the successor beneficiaries all had a testamentary general power of appointment. A pre October 22, 1942 power of appointment only has adverse estate tax consequences if it is exercised. Upon the death of Daughter or successor beneficiary, the heirs at law of that beneficiary would succeed to the beneficiary's interest in the trust. The court also ruled that after Daughter's death, each successor beneficiary would have three separate beneficial interests:

A. An income interest for 21 years after Daughter's death;

B. The remainder interest which vested in possession 21 years after Daughter's death; and

C. A pre-1942 general power of appointment.

The court ruled that each of those interests could be disclaimed independently of others.

Several years later, Daughter proposed to partially release her general power of appointment to restrict the power in two respects. First, the power was to be exercisable only in favor of the Daughter's estate. Second, the power could only be appointed to take effect after her death. The intention of Daughter was to allow her power of appointment over the trust to lapse at her death.

Subsequently, the trustee petitioned the supervising court, with the consent of the Daughter and other beneficiaries, to provide that when the trust terminated 21 years after the death of Daughter, any share distributed to a beneficiary under a specified age was to be held in a continuing trust until that beneficiary reached the specified age. If that beneficiary survived Daughter but died before reaching the specified age, the beneficiary would have a general testamentary power of appointment causing the property to be included in the beneficiary's estate. The later petition also requested the court to modify the trust to allow for the administration of the separate trusts created after the Daughter's death.

The taxpayer requested the following rulings:

A. The power of appointment granted to the great grandchildren who succeeded to the Daughter's interest in the trust would be considered a pre-October 22, 1942 power of appointment and the complete release or lapse of that power of appointment would not have any adverse estate, gift, or GST tax purposes.

B. The proposed disclaimer by any one or more of the great grandchildren would be a qualified disclaimer under Section 2518 and would not have any adverse gift tax or estate tax consequences to the disclaimants and would not result in the loss of the GST exempt status of the trust.

C. The assets of a continuing trust created pursuant to proposed modification after Daughter's death would be included in the estate of the beneficiary if the beneficiary died before the termination of the continuing trust.

D. The proposed construction of the trust would not cause the trust to be subject to GST tax.

E. The proposed construction of the trust would not result in a taxable gift by any of the beneficiaries of the trust.

With respect to the first ruling request, the Daughter had a pre-October 22, 1942 general power of appointment to which the grandchildren would succeed when the Daughter dies. To the extent that any grandchild disclaimed his or her interest in that power of appointment or died during the 21 year period following Daughter's death, some great grandchildren might succeed to her power of appointment. Based on the regulations to Section 2041, the power of appointment held by the great grandchildren and more remote beneficiaries would be considered a power created before October 22, 1942 and consequently the release or lapse of such a power would not treated as the exercise of the power and would have no adverse estate or gift tax consequences.

With respect to the second ruling request, Daughter's heirs cannot succeed to any interest in the trust until Daughter's death pursuant to the terms of the trust. Consequently, Daughter's great grandchildren could disclaim their interest and there would be no adverse estate or gift tax consequences.

With respect to the third and fourth ruling requests, the proposed modifications would not have any adverse generation-skipping tax consequences. The modification would fall within the scope of Treas. Reg. 26.2601-1(b)(4)(i)(D)(1) which provides that a modification of the governing instrument of an exempt trust is valid under applicable state law and will not have adverse GST consequences when the modification does not shift a beneficial interest to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification and the modification does not extend the time for the vesting of any beneficial interest in the trust beyond the period provided for in the original trust. That was the case here.

With respect to the fifth ruling request, because the proposed construction of the trust clarified ambiguous terms of the trust and reflected the rights of the party under applicable law, the proposed construction of the trust would not result in a taxable gift by any of the beneficiaries of the trust.

11. **Letter Ruling 201808002 (Issued November 16, 2017; Released February 23, 2018)**

Service rules on gift tax consequences of gift of life estate interest in pre-October 9, 1990 transaction

Prior to the enactment of Chapter 14 in 1990, husband, wife, and their six children purchased real estate from an unrelated party for the property's fair market value. Husband, wife, and each of the children executed an agreement whereby husband, wife, and each of the children paid the actuarial value of their respective interests from their own resources and none of the six children used any funds acquired from their parents to acquire their respective interests. Under the agreement, wife acquired a life interest in the use of and income from the real property, husband acquired a life

interest in the use of and income from the real property that became effective upon the death of the wife, and each of the children had a 1/6th undivided interest in the remainder.

The life tenants wished to give a geographically defined portion of the acreage of their life interest in the real property to the children. As a result, the six children would become the outright owners of that geographically defined real estate.

The taxpayers requested rulings that:

A. The remaining acreage of the real property after the transaction would continue to be treated as resulting from a pre-October 9, 1990 transfer for purposes of the application of Chapter 14.

B. The proposed gifts by the life tenants would be treated as gifts for federal gift tax purposes.

The proposed gifts by the life tenants would not result in any portion of the real property being included in the gross estate of either life tenant for estate tax purposes.

The Service first ruled that the conveyance of the real estate by the life tenants would be treated as gifts for federal gift tax purposes and that the gifts would be valued using the actuarial value of the individual life estate interests determined by the application of the appropriate Section 7520 rate. In addition, the life tenants would not be considered to retain any interest in, or any right to alter or revoke, or any reversion in the portion of the real estate that was conveyed to the remainder beneficiaries and that the transaction would not result in any adverse estate tax consequences to wife and husband. The Service held that the transaction would not be subject to the application of Chapter 14.

12. **Letter Ruling 201825003 (Issued March 9, 2018; Released June 22, 2018)**

Transfer of the legal title, naked ownership, and remainder interest in and to artwork as defined by the deed of transfer is a completed gift for gift tax purposes

Taxpayer and spouse owned an art collection. The taxpayer as a result of the spouse's death, became the sole owner of the artwork. Prior to the spouse's death, the taxpayer and the spouse entered into a deed of transfer with two museums outside of the United States under which they agreed to donate the artwork with the possession of the artwork by the museums to occur on the death of the second to die and spouse.

The deed of transfer provided that the taxpayers granted to the museums the legal title, naked ownership and remainder interest in and to the artwork. It also provided that the taxpayer expressly reserved a life interest and usufruct in and to the artwork which would automatically expire on the death of the taxpayers.

The deed provided the parties intended for the transfer not to qualify for gift tax purposes on the basis that the taxpayer was not releasing dominion and control over the artwork until death. If the

taxpayer received a favorable ruling from the IRS of the gift tax treatment, the donation is deemed to take effect as of the day of the favorable ruling. Certain conditions were imposed in the deed of transfer. The museums were to comply with the requirements regarding the housing, display, and exhibition of the artwork. The museums must not become privately owned and the tax laws must not change to cause the taxpayer to become subject to taxation in the country, during the taxpayer's life or upon death, in connection with the transfer of the artwork if the artwork was to be transferred to museums in a country other than the United States.

The IRS stated that upon the effective date of the deed of trust, the taxpayer would transfer legal title, naked ownership and the remainder interests of the artwork to the museums. During the period of the life interest and usufruct, the taxpayer would not sell or otherwise dispose of any of the artwork. The taxpayer retained no power to change the disposition of the artwork and was barred from doing so under the deed of trust. Even though the transfer of the artwork was subject to several conditions subsequent, the conditions that would cause a revocation of the transfer were not dependent on any act of the taxpayer. Consequently, the taxpayer's grant to the museums of the legal title, naked ownership, and remainder interest to the artwork would be a completed gift for gift tax purposes.

13. **Letter Ruling 201836006 (Issued May 30, 2018; Released September 7, 2018)**

Service rules on consequences of incomplete non-grantor trust

This letter ruling is one of the most recent letter rulings on the tax consequences of an incomplete non-grantor trust. In this letter ruling, grantor created an irrevocable trust. The beneficiaries were a class consisting of the grantor, the grantor's parents, the grantor's siblings, the grantor's nephew and niece, any issue of the grantor born or adopted after a specified date and any mutual issue of grantor's parents born or adopted after a specified date. A corporate trustee was the sole trustee of the trust.

The trust provided for a distribution committee consisting of the parents and the two siblings. The distribution committee had the power to appoint income and principal of the trust in a non-fiduciary capacity to one or more beneficiaries by unanimous vote (unanimous member power) and to appoint principal and income in a non-fiduciary capacity to one or more beneficiaries by a majority vote with the affirmative consent of the grantor (grantor's consent power). If no members of the distribution committee were then serving, the trustee could distribute income and principal on a discretionary basis for health, education, maintenance and support. An independent trustee could distribute income and principal in its sole and absolute discretion for any purpose.

The grantor in a non-fiduciary capacity could direct the trustee to distribute principal of the trust to or among the beneficiaries other than the grantor for health, education, support and maintenance (grantor's sole power).

The grantor had a broad limited testamentary power of appointment over the property and the trust. To the extent that the grantor did not exercise the broad limited testamentary power of

appointment, the property was to pass to grantor's children, otherwise, to his parents and their descendants.

The following rulings were requested:

1. During the period that the distribution committee was serving during the life of the grantor, there would be no income tax consequences to the grantor or any member of the distribution committee.

2. The grantor's contribution of property to the trust was not a completed gift, subject to federal gift tax.

3. Any appointment of trust property by the distribution committee to grantor would not be a completed gift by any member of the distribution committee.

4. Any appointment of trust property by the distribution committee to any beneficiary of the trust other than the grantor would not be a completed gift subject to federal gift tax by any member of the distribution committee.

5. No member of the distribution committee would be considered to have a Section 2041 general power of appointment over any property held in the trust.

The Service first ruled that none of the provisions of the trust would cause the grantor to be treated as the owner of the trust for income tax purposes as long as the distribution committee remained in existence and was serving under any of Sections 673, 674, 676, or 677. The Service then concluded that an examination of the trust revealed none of the circumstances that would cause administrative controls to be considered exercisable primarily for the benefit of the grantor under Section 675. A determination of whether Section 675 would cause the grantor to be treated as the owner of any portion of the trust for income tax purposes was deferred until the federal income tax returns of the parties were examined.

The Service next ruled that the contribution of property to the trust was not a completed gift. A distribution from the trust to grantor was merely a return of grantor's property. Upon grantor's death, the fair market value of the property in the trust was subject to tax in the grantor's gross estate.

The Service finally ruled that any appointment of trust property by the distribution committee to any beneficiary of the trust, other than the grantor, would not be a completed gift subject to federal gift tax by any member of the distribution committee. Instead, any such appointment would be a completed gift by the grantor. In addition, the powers held by the distribution committee were not general powers of appointment under Section 2041 and accordingly, no property held in the trust would be includible in the gross estate of any member of the distribution committee upon his or her death under Section 2041.

ESTATE INCLUSION

14. **CCA 201745012 (Issued August 4, 2017; Released November 9, 2017)**

Purchase of remainder interest in transferred property in which donor retained annuity, which purchase occurred on donor's deathbed during the term of the annuity, failed to replenish donor's taxable estate, and failed to constitute adequate and full consideration for gift tax purposes

Donor formed Trust 1, which was an irrevocable discretionary trust for the benefit of Donor's first spouse and issue. Trust 1 terminated on the later of the death of Donor or his first spouse, at which time the principal and any accumulated income were distributed outright to Donor's issue. Donor's first spouse predeceased him, and Donor then married second spouse. Later, Donor formed Trust 2, an irrevocable trust for the benefit of Donor and his issue. Under the terms of Trust 2, an annuity is payable to Donor for the term of the trust, and then the remainder is payable to his issue under the terms of Trust 1. Subsequently, Donor formed Trust 3, which had the same terms and provisions as Trust 2.

On what the Service described as Donor's "deathbed," Donor purchased the remainder interest in Trusts 2 and 3 from the trustees of Trust 1. Donor paid the purchase price with two unsecured promissory notes and died the following day.

Donor's estate reported the purchases of the remainder interest as non-gift transfers, asserting that Donor received adequate and full consideration in money or money's worth in the form of the remainder interest in Trusts 2 and 3.

The IRS ruled that where the purchase of the remainder occurs on Donor's deathbed during the term of the annuity, the remainder does not "replenish" the Donor's taxable estate. Consequently, the remainder does not constitute adequate and full consideration in money or money's worth for gift tax purposes pursuant to Merrill v. Fahs, 324 U.S. 308 (1945).

A companion Supreme Court case, Commissioner v. Wemyss, 324 U.S. 303 (1945), stands for the general proposition that "adequate and full consideration in money or money's worth" for gift tax purposes is that which replenishes or augments the donor's taxable estate. For example, B's relinquishment of marital rights in A's property will have no effect on the includable value of that property in A's gross estate. For that reason, the relinquishment of marital rights cannot replenish a donor's gross estate for estate tax purposes.

This memo noted that the relinquishment of marital rights did constitute valuable contractual consideration in the hands of Donor and did benefit Donor. This did not have the same effect for gift tax purposes. The Service noted that while Donor's liability on the promissory notes depleted Donor's taxable estate, that does not matter for tax purposes. The purchase of the remainder interest in transferred property in which Donor has retained a Section 2036 "string" over the received remainder does not increase the value of Donor's taxable estate because the value of the entire property, including that of the remainder, is includable in Donor's gross estate.

The IRS also ruled that a note given in exchange for property does not constitute adequate and full consideration in money or money's worth for gift tax purposes is not deductible as a claim against the estate.

15. **Badgley v. United States, _____ F.Supp.3d _____ (N.D. Cal 2018)**

The assets of a GRAT are included in the settlor's estate

On February 1, 1998, Patricia Yoeder created a grantor retained annuity trust. Patricia was to receive annual annuity payments for the lesser of fifteen years or her prior death in the amount of 12.5 percent of the date of gift value of the property transferred to the GRAT. The GRAT paid Patricia an annuity of $302,259. Upon the end of the annuity term, the property was to pass to Patricia's two living daughters. The GRAT also stated that, if the trustor failed to survive the trust term, the trustee was to pay all the remaining annuity amounts and the portion of the trust included in the trustor's estate to the survivor's trust created under Patricia's revocable trust.

Patricia died on November 2, 2012 having received her last annuity payment from the GRAT on September 30, 2012, two months before the expiration of the annuity term.

The federal estate tax return reported a gross estate of $36,829,057, including the value of the assets held in the GRAT. The estate paid federal estate taxes of $11,187,457. On May 16, 2016 the estate filed a claim of refund seeking $3,810,004 in estate tax overpaid by the estate as a result of the inclusion of the full value of the GRAT. The case was before the court on cross-motions for summary judgment from the government and the estate.

The estate moved for summary judgment on two bases, asserting that Section 2036(a)(1) did not apply to Patricia's GRAT and that Treas. Reg. § 20.2036-1(c)(2) was overly broad and invalid to the extent that it applied to the GRAT and that the transfer of property the GRAT was a bona fide sale for full and adequate consideration and Section 2036 did not apply to cause inclusion of the property in the GRAT in the estate. The government moved for summary judgment on the opposite grounds. The estate argued that a "fixed-term annuity" was not the same as a right to income or some other form of possession or enjoyment as required by Section 2036(a)(1). However, the government relied on three cases that took a broad approach to the operative language of Section 2036 and its predecessor: C. I. R. v. Church's Estate; 335 U.S. 632 (1939); Spiegel's Estate v. Commissioner, 335 U.S. 701 (1949); and Helvering v. Hallock, 309 U.S. 106 (1940). The court found that Section 2036 applied to the GRAT. Although plaintiff was correct that the government's authorities did not expressly equate a fixed-term annuity with a right to income or some other possession or enjoyment, the Supreme Court had adopted a substance over form approach that favored a finding that the annuity comprised some form of possession, enjoyment, or right to income from the transferred property.

Treas. Reg. 20.2036-1(c)(2)(i) requires that transferred GRAT property be included in a decedent's gross estate where the decedent retains an annuity interest and dies before the expiration of the annuity term. The court found that the regulation was valid even though Section 2036 does not equate "income" with a fixed term annuity in Section 2036. The silence did not mean that the interpretation of the Section is arbitrary or capricious. Instead the regulation is a permissible

interpretation of Section 2036. The court also rejected the argument that the regulation was arbitrary because it would result in the inclusion of all private annuities in the decedent's gross estate and was overly broad to the extent that the regulations subsequently included GRATs such as Patricia's that "have no ordering rule, do not provide for income payments disguised as annuity payments, and at the time of grantor's death can satisfy the annuity payments entirely out of principal." The second argument failed once the court rejected the attempted distinction between an annuity and a right to income.

The court also rejected the argument that the creation of the GRAT was property transferred to the GRAT in a bona fide sale in exchange for an annuity. The court noted that the funding of the GRAT does not involve selling the transferred property to a third party in exchange for an annuity. There is no other owner of property engaging in the sale transaction other than the transferor.

Finally, the formula used to determine the included value of the GRAT was reasonable even though it assumed that the annuity was paid solely from income. The estate argued that an annuity can, in fact, be paid from either principal or income and thus the formula yielded a capriciously large amount to be included for tax.

As a result, Patricia's GRAT was properly included in calculating the value of her gross estate.

VALUATION

16. Letter Ruling 201819010 (Issued February 8, 2018; Released May 11, 2018)

IRS grants extension of time to make Section 754 election

A general partnership was organized under state law. A and B owned a percentage interest in the partnership as community property. B died. The executor intended to make an election under Section 754 in connection with the death of B to step up the basis of partnership property. However, the executor failed to file a timely return to make the election. The executor represented that it had acted reasonably and in good faith and that granting the relief would not prejudice the interests of the government.

Treas. Reg. § 1.754-1(b)(1) provides that an election under Section 754 to adjust the basis of partnership property is to be made in a written statement filed with a partnership return for the taxable year in which the distribution or transfer occurs. For the election to be valid, the return must be filed not later than the time prescribed for filing the return for the taxable year. Under Treas. Reg. §§ 301.9100-1 and 301.9100-3, a request for an extension of time to make an election will be granted when a taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that the grant of the relief will not prejudice the interests of the government. In this situation, the Service found that the requirements of Treas. Reg. §§ 301.9100-1 and 301.9100-3 were satisfied and granted an extension of time to make the Section 754 election

17. Letter Ruling 201814004 (Issued December 11, 2017; Released April 6, 2018)

IRS allows extension of time to make special use valuation election for farmland

Upon decedent's death, son and daughter were co-trustees of her revocable trust and co-executors of her estate which included farmland. Son and daughter retained an accountant to prepare and file the Form 706. The accountant failed to advise son and daughter to make the Section 2032A special use valuation election for the farmland. The son and daughter timely filed the Form 706.

After filing the Form 706, the son met with an attorney to discuss estate planning. The attorney discovered that the special use valuation election was never made on the Form 706. As a result of this discovery, the estate requested an extension of time to make the special use valuation election.

Under Treas. Reg. §§ 301.9100-1 and 301.9100-3, an extension of time to make an election will be granted if the IRS determines that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. The taxpayer is deemed to have acted reasonably and in good faith if the taxpayer relied on a qualified tax professional and the tax professional failed to advise the taxpayer to make the election.

The Service ruled that the requirements of Treas. Reg. §§ 301.9100-1 and 301.9100-3 had been satisfied and an extension of time to make the special use valuation election was granted.

18. Letter Ruling 201820010 (Issued February 13, 2018; Released May 18, 2018)

IRS allows extension of time for estate to elect alternate valuation date

The executor of decedent's estate consulted an attorney to prepare the Form 706. The Form 706 was timely filed however, the attorney failed to make the alternate valuation election under Section 2032 on the initial Form 706. The executor now requested an extension of time to make the alternate valuation election and use the alternate valuation method in reporting the value of the gross estate on the return.

Under Treas. Reg. §§ 301.9100-1(c) and 301.9100-3, the IRS may grant an extension of time if the taxpayer shows that the taxpayer acted reasonably and in good faith and that the granting of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer failed to make the election because, after exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election.

The IRS ruled that the requirements of regulations had been satisfied and granted an extension of time to make the alternate valuation election.

19. **Letter Ruling 201815001 (Issued December 11, 2017; Released April 13, 2018)**

IRS allows extension to elect alternate valuation date

Upon decedent's death, the executor of the estate consulted CPA to prepare the Form 706 which was timely filed. CPA failed to make the alternate valuation election under Section 2032 on the Form 706. The CPA stated in an affidavit that he intended to make the alternate valuation election, but failed to check the box. The executor requested an extension of time to make the alternate valuation method election.

Under Treas. Reg. §§ 301.9100-1 and 301.9100-3, a reasonable extension of time may be granted if the taxpayer proves that the taxpayer acted reasonably and in good faith and the granting of relief will not prejudice the interests of the government. The taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make the election.

The Service ruled that the requirements of the regulations had been satisfied and granted an extension of time to make the alternate valuation date election.

20. **Letter Ruling 201825013 (Issued March 19, 2018; Released June 22, 2018)**

IRS grants an extension of time to make the alternate valuation election

After decedent's death, the co-executors hired an attorney to prepare the estate tax return. The attorney prepared the estate tax return but failed to make the alternate valuation date election. The estate tax return was timely filed. Subsequently, after the due date of the estate tax return, the co-executors filed a supplemental estate tax return making the Section 2032 election. The Service then issued a letter to the estate stating that since the alternate valuation election was not made timely, the assets could only be valued using the alternate valuation date if an extension of time was granted under the relief provisions of Treas. Reg. §§ 301.9100-1 and 301-9100-3.

In this letter ruling, the IRS concluded that the standard of those treasury regulations were satisfied. Treas. Reg. § 301.9100-3 states that an extension of time for that relief will be granted if the taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional.

21. Estate of Clara M. Morrissette v. Commissioner, Tax Court Order, Docket No. 4414-14 (June 21, 2018)

Court denies partial summary judgment motion of estate that Section 2703 does not apply to split-dollar arrangement

Split-dollar is a method of financing the purchase of insurance. It most typically takes the form of an arrangement between a closely held business and an owner-employee, or between a public corporation and its executives, in which the employer and employee agree to split the payment of premiums on an insurance policy on the life of the insured. In 2001, the IRS announced its intent in Notice 2001-10, 2001-1 C.B. 459, to change its tax treatment of split-dollar arrangements. Thereafter, it issued new regulations, in final form, on September 17, 2003. The new taxation scheme created under these regulations significantly altered the way in which split-dollar arrangements were used for estate planning purposes thereafter.

Under the regulatory scheme put in place in 2003, two mutually exclusive methods for taxing split-dollar life insurance arrangements now apply, the economic benefit regime and the loan regime. If the employer is the owner of the insurance policy, the split-dollar arrangement will be taxed as compensation related agreement under the economic benefit regime. The value of the current life insurance protection and any other benefits derived by the insured employee from the arrangement will be treated as taxable income to the employee under Section 61 of the Internal Revenue Code. The economic benefit rules apply to both arrangements where the policy is actually owned by the employer (endorsement method split-dollar arrangements) and to arrangements in which the employee owns the policy (collateral assignment split-dollar arrangements) but the employee's only right is to the insurance protection. In this latter situation, the employer will be deemed to own the policy. Treas. Reg. § 1.61-2(c)(1)(ii)(A)(2).

Any split-dollar arrangement not described above in which the employee owns the policy will be governed under the loan regime by the Section 7872 below market loan rules. Transfers by the employer will be treated as loans and there will be deemed interest to the extent that the arrangement does not mandate adequate interest. The deemed interest will treated as compensation paid by the employer to the employee and then repaid as interest by the employee. The same rules will apply to split-dollar arrangements in all other contexts, such as shareholder-company and private donor-donee arrangements.

Morrissette involved a motion for partial summary judgment in a private donor-donee arrangement. The unique feature here is that the insureds were much younger than the donor. In Morrissette, Clara Morrisette established a revocable trust in 1994 to which she contributed all of her shares in Interstate Group Holdings which, in turn, held eleven moving and other companies. In September 2006, when Clara Morrissette was 93, her three sons became trustees of the revocable trust. Previously, on August 18, 2006, an employee of Interstate Group Holdings was appointed as a temporary conservator of Clara's Morrisette's estate through October 20, 2006. The conservator transferred additional assets into the revocable trust. In addition, the conservator established three perpetual dynasty trusts in 2006, one for each of her three sons and his family. The revocable trust was amended on September 19, 2006 to permit the trustees to pay premiums on life insurance and to make loans and to enter into split-dollar arrangements.

Next, on September 21, 2006, the dynasty trusts, the three brothers, the revocable trust, and other trusts holding interests in Interstate Group Holdings entered into a shareholders agreement providing that upon the death of each brother, the surviving brothers, and the dynasty trusts would purchase the Interstate Group Holdings stock held by or for the benefit of the deceased brother. To provide each dynasty trust with the funds to purchase the Interstate Group Holdings stock held by a deceased sibling, each dynasty trust on October 4, 2006 purchased a universal life policy on the life of each of the two other brothers.

Clara Morrissette's revocable trust on October 31, 2006 entered into two split-dollar life insurance arrangements with the three dynasty trusts and then contributed $29.9 million in total to the three dynasty trusts in order to fund the purchase of the universal life insurance policies on each of Clara Morrissette's three sons. The split-dollar life insurance arrangements provided that the revocable trust would receive the greater of the cash surrender value of the respective policy or the aggregate premium payments on that policy upon termination of the split-dollar life insurance arrangement or the death of the insured brother. The right to receive a portion of the death benefit would thus be a receivable of the revocable trust.

Each split-dollar agreement provided that the agreement would be taxed under the economic benefit regime and that the only economic benefit provided to each dynasty trust was the current life insurance protection. The dynasty trusts executed collateral assignments of the policies to the revocable trust to secure the payment of the amounts owed to the revocable trust. Neither the dynasty trusts nor the revocable trust retained the right to borrow against the policies.

In each of 2006 through 2009, Clara Morrissette reported gifts to the dynasty trusts under the economic benefit regime of the cost of the current life insurance protection determined under Table 2001 less the amount of the premiums paid by the dynasty trusts. Clara Morrissette died on September 25, 2009 and was survived by her three sons. After Mrs. Morrissette's death, the estate retained Valuation Services, Inc. to value the receivables included in the gross estate as of the date of her death. Valuation Services, Inc. valued the receivables at $7,479,000.

The IRS in the audit of Clara Morrissette's estate determined that the $29.9 million contribution was a gift in 2006 and assessed a gift tax deficiency against Clara Morrissette's estate of $13,800,179 and a penalty of $2,760,036. The estate moved for partial summary judgment on the narrow issue of whether the split-dollar insurance arrangements were governed by the economic benefit regime under Treas. Reg. § 1.61-22.

In Estate of Clara M. Morrissette, 176. T.C. No. 11 (April 13, 2016), the Tax Court first noted that the 2003 final regulations governed the split-dollar arrangements since they were entered into after September 17, 2003. The court also noted that generally the person named is the owner in the insurance contract is treated as the owner of the contract. Under this general rule, the dynasty trusts would be considered the owners of the policies and the loan regime would apply. However, the final regulations included the special ownership rule that provided that, if the only economic benefit provided under the split-dollar life insurance arrangement to the donee is the current life insurance protection, then the donor will be deemed the owner of the life insurance contract, irrespective of actual policy ownership, and the economic benefit regime will apply.

To the court, the key question was whether the lump sum payment of premiums made directly made by the revocable trust on the policies in 2006 generated any additional economic benefit other than the life insurance protection to the dynasty trusts. If there was no additional economic benefit to the dynasty trusts, then the revocable trust would be deemed the owner of the policies by way of the special ownership rule and the split-dollar life insurance arrangements would be governed by the economic benefit regime. To determine whether any additional economic benefit was conferred, the relevant inquiry was whether the dynasty trusts had current access to the cash values of the respective policies under the split-dollar life insurance arrangement or whether any other economic benefit was provided. The court determined that the dynasty trusts did not have access to any part of the cash value of the insurance policies or to any other economic benefit except for the current life insurance protection. As a result, the economic benefit regime and not the loan regime applied.

The important issue yet to be determined with respect to Morrissette is the value of the receivables in Clara Morrissette's estate for estate tax purposes and whether the receivables should only be valued at approximately $7,500,000. The resolution of this issue will determine the usefulness for estate and gift tax purposes of the split-dollar financing of the policies in this particular situation.

On December 5, 2016, the estate moved for partial summary judgment that Section 2703 does not apply for purposes of the valuation of Clara Morrissette property rights under the split-dollar arrangements estate tax. Section 2703(a) provides that for transfer tax purposes with respect to buy-sell and similar arrangements between family members, the value of properties are determined without regard to (1) any option, agreement, or other right to acquire or use property at less than fair market value, or (2) any restriction on the right to sell or use the property.

As noted above, the decedent entered into split-dollar arrangements through her revocable trust with the three dynasty trusts that had been established in the name of each of her three sons. The court held that the economic benefit regime applied and the cost of the current insurance protection was a transfer each year from the decedent to the son for gift tax purposes. The parties agreed that for estate tax purposes the estate must include the decedent's rights under the split dollar arrangements in the gross estate. The parties disagreed over exactly what rights the decedent had over the split-dollar arrangements and whether those rights were subject to any restrictions pursuant to Section 2703(a)(2). The estate argued that the decedent's only right under the split-dollar arrangement was the death benefit and that right was without restriction. The government argued that the decedent's right also included the right to terminate the split-dollar agreements with the consent of the other party at any time and to receive a payout upon termination. It argued that the termination rights were restricted by the split-dollar arrangements and that Section 2703(a)(2) applied to disregard the termination restrictions. The IRS also argued that decedent had rights under the collateral assignment agreements and that those restrictions should be disregarded. As a result, summary judgment should be denied because there was a genuine issue of material fact.

Pursuant to Estate of Cahill v. Commissioner, T.C. Memo 2018-84, a restriction on a decedent's termination rights is a restriction for purposes of Section 2703. In Estate of Cahill, the Tax Court denied the estate's motion for partial summary judgment that Section 2703(a) did not apply to split-dollar arrangements with termination restrictions similar to those at issue in Morrissette

where the parties to the agreements can mutually agree to terminate the arrangement but neither party could unilaterally terminate the arrangements. Here the decedent's trust and the respective dynasty trusts could mutually agree to terminate the split-dollar arrangement but neither party could unilaterally terminate the agreement.

As a result, Judge Goeke denied the motion for partial summary judgment.

22. <u>Cahill v. Commissioner</u>, T.C. Memo 2018-84; settled, Joint Stipulation of Settled Issues, Tax Court Docket 10451-16 (August 16, 2018)

Taxpayer's motion for summary judgment with respect to split-dollar arrangement is denied

Richard F. Cahill died on December 12, 2011. His son, Patrick Cahill, was named as executor. This case involves three split-dollar agreements that were executed in 2010 when Richard was 90 years old and unable to manage his own affairs.

Richard was the settlor of a revocable trust called the Survivor Trust. Patrick was the trustee of the Survivor Trust and was also decedent's attorney-in-fact under a California Power of Attorney. Richard's involvement in the three split dollar life insurance arrangements was effected solely through the Survivor Trust and was directed by Patrick Cahill either as decedent's attorney in fact or as trustee of Survivor Trust. The parties agreed that everything in the Survivor Trust on decedent's date of death was included in the decedent's gross estate. Decedent was also settlor of the Morrison Brown ("MB") Trust which was created in September 2010 by Patrick Cahill as decedent's agent. William Cahill was trustee of the MB Trust and the primary beneficiaries of the MB Trust were Patrick and his issue. The MB Trust owned three whole life insurance policies. Two policies were on the life of Shannon Cahill, Patrick Cahill's wife, and one policy was on the life of Patrick Cahill. The policy premiums were paid in lump sums as shown in the chart below.

	Policy Premium	**Policy Amount**
New York Life on Patrick Cahill	$5,580,000	$40,000,000
SunLife on Shannon Cahill	$2,531,570	$25,000,000
New York Life on Shannon Cahill	$1,888,430	$14,800,000
TOTAL	**$10,000,000**	**$79,800,000**

To fund these policies, three separate split-dollar agreements were executed by Patrick Cahill, as the trustee of the Survivor Trust, and William Cahill as trustee of the MB Trust. The Survivor Trust paid the premiums using funds from a $10 million loan from Northern Trust. The obligors on the loan were the decedent personally and Patrick Cahill as trustee of the Survivor Trust. Each split dollar arrangement was designed to take advantage of the economic benefit regime and avoid the loan regime. Upon the death of the insured, the Survivor Trust was to receive a portion of the death benefit equal to the greatest of the remaining balance on the loan, the total premiums paid with respect to the policy, or the cash surrender value. The MB Trust would retain any excess.

Each split-dollar agreement also provided that it could be terminated during the insured's life by written agreement between the trustees of the Survivor Trust and the MB Trust. As of the date of

Richard's date in 2011, the aggregate cash surrender value of the policies was $9,611,624. The estate's tax return reported the total value of decedent's interest in the split-dollar agreements at $183,700. In the Notice of Deficiency, the IRS adjusted the total value of decedent's rights in the split-dollar arrangements from $183,700 to $9,611,624, the cash surrender value of the policies.

The estate moved for partial summary judgment. A court may grant summary judgment when there is no genuine dispute as to any material facts and a decision may be granted as a matter of law. The court first found that Section 2036 and Section 2038 would apply in this situation. The estate tried to argue that neither Section applied because the decedent retained no rights with respect to the amounts transferred to justify application of those Sections. However, the court noted that the decedent retained the right to terminate and recover at least the cash surrender value held in conjunction with the MB Trust and that those constituted rights under Section 2036 and Section 2038. The court then noted that with respect to the requirements in Sections 2036 and 2038, questions remained as to whether decedent's transfer of $10 million was part of a bona fide sale. It also noted that the issue of whether the transfer was for full and adequate consideration was a question of fact. It stated that the bona fide sale for adequate and full consideration exception was not satisfied because the value of what the decedent received was not even close to the value of what decedent paid.

The court also reviewed the argument of the government that Section 2703 would apply to the MB Trust's ability to veto termination of split-dollar arrangements. It found that split dollar agreements, taken as a whole, clearly restricted decedent's right to terminate the agreements and withdraw his investment from those arrangements. The court stated that the requirements of Sections 2703 were met and therefore denied the motion for summary judgment with respect to this. The court also noted that the parties had not addressed the exception in Section 2703(d) which provides for comparison with the terms of any similar arrangements entered into by persons in arms' length transactions.

The court also rejected the estate's contention that any part of the difference between the $183,700 that decedent allegedly received in return and the $10 million decedent paid would be accounted for as gifts and that to count the difference as part of the estate under Sections 2036, 2038 and 2703 would be double counting.

The estate also sought summary judgment that pursuant to Treas. Reg. § 1.61-22, the economic benefit regime would apply to split dollar arrangements. The IRS countered that the regulation did not apply for estate tax purposes and stated that the economic benefit regime rules only are gift tax rules. The court noted that to the extent that the regulations eliminated the gift tax treatment and that those transfers are relevant to the estate tax issues it would look at the regulations in deciding the case. The estate also argued that the court should modify the approach required by Sections 2036, 2038 and 2703 to avoid inconsistency between the statutes and the regulations. The court disagreed. First, it found no inconsistency between the estate tax statutes and the income tax regulations. It also disagreed with the estate's argument, which was confusing to the court, that because Treas. Reg. § 1.61-22 did not deem the difference to be a gift, then the entire $10 million transferred must have been for full and adequate consideration. As a result, the estate's motion for partial summary judgment was denied. The government did not move for summary judgment on any of the issues discussed.

The government and the estate settled on August 16, 2018. The estate conceded that the value of the decedent's rights in the split dollar arrangements was $9,611,624, the cash surrender value of the policies, the amount asserted by the government. The estate was also liable for a Section 6662 20 percent accuracy related penalty.

23. **Streightoff v. Commissioner, T.C. Memo 2018 - 178**

Court accepts government's valuation of limited partnership interests in decedent's estate

Decedent, Frank Streightoff, was a resident of Texas when he died in 2011. During decedent's lifetime, his daughter, Elizabeth Streightoff, held the decedent's power of attorney.

On October 1, 2008, decedent through Elizabeth Streightoff, formed Streightoff Investments LP as a Texas Limited Partnership. Streightoff Investments during decedent's life did not hold meetings or have votes.

The partnership agreement stated that the purpose of Streightoff Investments was to make a profit, increase wealth, and provide a means for decedent's family to manage and preserve family assets.

Decedent funded Streightoff Investments with marketable securities, municipal bonds, mutual fund investments, other investments, and cash. As of January 31, 2009, 61.6 percent of Streightoff Investments 'assets consisted of marketable securities, 23.6 percent consisted of fixed income investments in municipal bonds, and 13.3 percent was invested in mutual funds.

Streightoff Management LLC was the sole general partner of Streightoff Investments. Elizabeth Streightoff was the manager of Streightoff Management. The Streightoff Investments partnership agreement provided that the general partner was in charge of conducting the business of the partnership. Decedent, his daughters, his sons and his former daughter-in-law were the original limited partners under the partnership agreement. The limited partners other than decedent received their limited partnership interest as gifts. Upon formation, decedent and the other partners had the following interests:

Partner	Percentage	Type
Streightoff Investments	1.00%	General
Decedent	88.99%	Limited
Elizabeth Streightoff	1.54%	Limited
Ann Fennell Brace	1.54%	Limited
Camille Schuma	1.54%	Limited
Jennifer Ketchurn Hodges	1.54%	Limited
Hilary Dan Billingalea	1.54%	Limited
Charles Franklin Streightoff	1.54%	Limited
Frank Hatch Streightoff	1.54%	Limited
Priscilla Streightoff	1.54%	Limited

Section 7.2 of the partnership agreement provided that a limited partner could not sell or assign an interest in Streightoff Investments without obtaining the written approval of the general partner, which approval would not be unreasonably withheld. Any partner who assigned his or her interest remained liable to the partnership for promised contributions or excessive distributions unless and until the assignee was admitted as a substitute limited partner.

On October 1, 2008, the same day that the decedent formed Streightoff Investments, he established the Frank D. Streightoff Revocable Living Trust and transferred his 88.99 percent interest in Streightoff Investments to the Revocable Trust. Frank Streightoff was the sole beneficiary and Elizabeth Streightoff was the trustee of the revocable trust. On October 1, 2008, decedent, through Elizabeth Streightoff executed an assignment of interest which designated the decedent as assignor and the revocable trust as assignee of the limited partnerships interests. Elizabeth Streightoff signed the transfer agreement in her capacities as the holder of the decedent's power of attorney, trustee of the revocable trust, and managing member of Streightoff Management.

After decedent's death in 2011, on decedent's federal estate tax return, Elizabeth Streightoff, as executor, elected the alternate valuation date. The net asset value of the 88.99 percent assets in the partnership on the alternate valuation date was $7,307,951. The estate used a combined 37.2 percent discount for lack of marketability, lack of control, and lack of liquidity, and reported the value of the limited partnerships interest as $4,588,000.

The court first had to determine whether the interest transferred to the revocable trust was a limited partnership interest or assignee interest. It noted that the federal tax effect of particular transactions is governed by the substance of the transaction rather than its form. The court concluded that the decedent transferred a limited partnership interest to the revocable trust and not an assignee interest. The economic realities underlying the decedent's interest also support the court's conclusion that the transferred interests should be treated as limited partnership interests for estate tax purposes. That was because, regardless of whether an assignee or limited partnership interest had been transferred, there would have been no substantial difference before or after the transfer of the limited partnership interests to the revocable trust. Also, even though an assignee could not vote, the partnership held no votes before decedent's death.

The court then looked at the appropriate valuation of the limited partnership interests. The IRS used Juliana Vicelya and the estate used Howard Frazier Barker Elliot (HFBE). The court first determined that there was no discount for lack of control since the interest transferred was an 88.99 percent limited partnership interest which could control the partnership. It noted that limited partners with a 75 percent interest could remove general partners and a general partner's removal terminated the partnership. This gave decedent's interest control over the partnerships.

HFBE valued the interest as an assignee interest and concluded that a 13.4 percent discount for lack of control should be applied. Since the court determined that a limited partnership interest and not an assignee interest was transferred, a discount for lack of control was not appropriate. The IRS's appraiser determined that an 18 percent discount for lack of marketability was appropriate. This was based on the highly liquid nature of the underlying assets of the partnership. In addition, the diversification of the underlying assets would make an interest in the partnership attractive to a hypothetical buyer, and the amount of control provided to an 88.99 percent limited

partnership interest was a factor favoring a lower discount. Finally, the right of first refusal in the partnership agreement warranted a lower discount. HFBE concluded that a 27.5 percent discount for lack of a marketability was appropriate. However, one HFBE appraiser testified that his analysis of the lack of marketability discount would have included different considerations if the interest was a limited partnership interest with voting rights under the partnership agreement, as the court determined. Consequently, the court determined that the interest should be valued using an 18 percent discount rate for lack of marketability as the IRS' appraiser proposed.

24. Estate of Turner v. Commissioner, 151 T.C. No. 10 (2018) (Turner III)

Tax Court addresses tax issues arising from inclusion of family limited partnership interests in estate of first spouse to die

In April 2002, Clyde W. Turner, Sr. ("Clyde Sr.) and his wife Jewell formed a limited partnership, each transferred $4,333,671 in cash, CDs, and publicly-traded securities to the partnership, and each took back a 0.5% general partner interest and a 49.5% limited partner interest. On December 31, 2002, and January 1, 2003, they gave limited partner interests to children and grandchildren and an irrevocable trust for one child. Clyde Sr. became seriously ill and was hospitalized in October 2003 and died on February 4, 2004.

In Estate of Turner v. Commissioner, T.C. Memo. 2011-209 (Aug. 30, 2011) (Turner I), the Tax Court (Judge Marvel) rejected Clyde Sr.'s executor's claims of nontax purposes of asset management and protection and resolution of family disputes, viewed the creation of the partnership as "a part of a testamentary plan" in which Clyde Sr. retained both enjoyment and control, and thus found that the value of the assets he had transferred to the partnership was included in his gross estate under Section 2036(a)(1) and (2).

In Estate of Turner v. Commissioner, 138 T.C. 306 (March 29, 2012) (Turner II), the executor returned to the court to seek reconsideration of its 2011 decision, which the court denied, and to claim in the alternative that a reduce-to-zero pecuniary bequest nevertheless protected the estate from estate tax by providing an increased marital deduction. The court held, in effect, that even though the value of the assets was pulled back into the gross estate, the transferred assets were out of Clyde Sr.'s control and therefore could not pass to Jewell or qualify for a marital deduction.

As clarified in Turner III, the result of Turner II was that "the only taxable portion of the estate is the portion attributable to the Section 2036 inclusion" (implying, although not explicitly saying, that the entire estate still within Clyde Sr.'s control and therefore disposable at his death was allocated to the marital bequest). Therefore, in the calculation of the estate tax liability following Turner II, the IRS asserted in Turner III that "the estate must reduce the marital deduction by the amounts of Federal estate and State death taxes the estate must pay because the only property available to fund the payments is property that would otherwise pass to Jewell and qualify for the marital deduction."

In Turner III, the court rejected the IRS' argument and held that the original marital deduction is still preserved because any payment by the executor out of assets allocated to the marital bequest

(which were the only assets left) would entitle the executor to recovery under Section 2207B(a), which provides:

"(1) In general.—If any part of the gross estate on which tax has been paid consists of the value of property included in the gross estate by reason of Section 2036 (relating to transfers with retained life estate), the decedent's estate shall be entitled to recover from the person receiving the property the amount which bears the same ratio to the total tax under this chapter which has been paid as—

"(A) the value of such property, bears to

"(B) the taxable estate.

"(2) Decedent may otherwise direct.—Paragraph (1) shall not apply with respect to any property to the extent that the decedent in his will (or a revocable trust) specifically indicates an intent to waive any right of recovery under this subchapter with respect to such property."

The court noted (at p. 14) that Clyde Sr.'s will did not address the payment of taxes or their apportionment, which the court found "not surprising because Clyde Sr. did not know that the Court would apply Section 2036 to his lifetime transfers." The court also noted, however, that Clyde Sr.'s will "clearly manifests his intention that the marital deduction not be reduced or diminished by the estate's tax liabilities." (In fact, the reduce-to-zero marital bequest, quoted in Turner II, includes the phrase "undiminished by any estate, inheritance, succession, death or similar taxes.") The court concluded:

"Accordingly, we hold that the estate need not reduce the marital deduction by the amount of Federal estate and State death taxes it must pay because the tax liabilities are attributable to the Section 2036 assets, the estate has the right to recover the amount paid under Section 2207B, and the estate must exercise that right to recover to give effect to Clyde Sr.'s intention that Jewell receive her share of the estate undiminished by the estate's tax obligations."

The court also rejected the executor's contention that the marital deduction should be increased by the amount of income generated after Clyde Sr.'s death by assets attributable to the marital share.

Turner III is not especially interesting because it tells us rules of law we did not know about. It is interesting because of the peculiar and questionable way in which it applies the rules we do know, and the implications we now see these rules might have beyond their customary context.

First, Turner I provided that the value of the assets Clyde Sr. transferred to the partnership in April 2002 was included in his gross estate, not the value of the gifts of partnership interests he made on December 31, 2002, and January 1, 2003. Who then is "the person receiving the property" from whom Section 2207B(a)(1) gives his executor a right of recovery? Is it not the partnership? If so, how is recovery obtained? And would not recovery from the partnership reduce the value of all interests in the partnership, including, after all, Jewell's interests? Or was the "transfer" contemplated by Section 2207B(a)(1) not complete until and to the extent of Clyde Sr.'s gifts, so the recovery, if it comes from the partnership, must somehow come from the partnership interests

of those transferees? Would not that be contrary to the recent application of Section 2036 in family limited partnership cases even to the assets represented by the partnership interests the partner retains until death?

Second, the recovery Turner III apparently contemplates, as quoted above, is "the amount of *Federal estate and State death taxes* [the estate] must pay because the tax liabilities are attributable to the Section 2036 assets" (emphasis added). In fact, the opinion uses the phrase "Federal estate and State death taxes" ten other times, including as the heading for its discussion of the right of recovery. But Section 2207B says nothing about state taxes. Clyde Sr. died domiciled in Georgia, a state with an estate tax coupled with the federal credit for state death taxes, and he died in 2004, when the federal state death tax credit had been phased down to 25% but not eliminated.

Third, footnote 2 of Turner III opinion states that Clyde Sr.'s wife Jewell had died on July 8, 2007, and that a related case for her estate (Docket No. 29411-11) was pending in the Tax Court. The petition was filed December 23, 2011, and the IRS's motion of August 3, 2012, for continuance of the trial was granted August 29, 2012, and there are no entries in the docket since August 29, 2012. If Clyde Sr.'s executor does not seek and obtain the recovery contemplated by Section 2207B(a), or if he does anything else in a manner the IRS dislikes, Jewell's estate's pending matter gives the IRS one more setting in which to raise its concerns, for example by asserting that Jewell was deemed to make a gift or her gross estate is enhanced by the full marital deduction Clyde Sr.'s executor eventually takes into account.

Fourth, if every lifetime transfer potentially subject to Section 2036 now carries with it the potential for recovery from the transferee for additional estate taxes that might be paid, who can tell what use could be made of that potential in discounting the value of those transfers even further? A comparison could be made to Steinberg v. Commissioner, 145 T.C. 184 (2015), the "net net gift" case in which the court allowed a reduction in the value of a gift for the actuarially calculated value of the donee's assumption of the obligation to pay the additional estate tax under Section 2035 if the donor died within three years of the gift. The problem is that in *Steinberg* the taxpayer conceded that there would be an increase in the gross estate under Section 2035 if the donor died within three years. It is hard to imagine any donor conceding a Section 2036 inclusion at the time of a transaction like the creation of the partnership in *Turner III*.

Fifth, Clyde Sr. died in February 2004. His executor filed the estate's Tax Court petition in August 2008. There are a total of 82 entries in the Tax Court docket for the estate over the last ten years, although, curiously, none between February 2013 and April 2017. One could ask if this hassle and delay is worth it.

25. **Kress v. United States, ____ F.Supp. 3d ____ , 2019 WL 1352944 (E.D.Wis. 2019)**

Tax Court rejects IRS's valuation of minority interests in closely held S Corporation stock given to family members over three years

Kress involved gifts of stock in Green Bay Packaging, Inc., a closely held S Corporation based in Green Bay, Wisconsin ("GBP") to family members. GBP was a vertically integrated manufacturer of corrugated packaging and related products. It employed approximately 3,400 people in fourteen states. In addition to the operating business, GBP had non-operating assets, including two aircraft, certain unrelated investments, and group life insurance policies. Approximately ninety percent of the common stock was owned by members of the Kress family and the remaining ten percent was owned by employees and directors.

When GBP sold shares to its employees and directors, the purchase price for those shares was 120% of the book value of each share. No price was established for shares that were transferred to members of the Kress family. Certain restrictions limited the ability to sell both family owned shares and non-family owned shares. A right of first refusal restriction in the GBP bylaws required that employee or director shareholder give GBP written notice of his or her intent to sell and offer to sell the shares back to GBP before selling to others. With respect to family-owned shares, a bylaw restriction required that Kress family members only give, bequeath or sell shares to other members of the Kress family.

Plaintiffs, James and Julie Kress, gave shares of GBP stock representing minority interests in the company to children and grandchildren in 2006, 2007, 2008 which gifts were reported on gift tax returns for 2007, 2008, and 2009. The shares were valued as follows:

Gift Tax Year	**Price Per Share**
2007	$28.00
2008	$25.90
2009	$21.60

Each of the two donors paid $1,219,241 in gift taxes with respect to the gifted shares for a combined total gift tax of $2,438,482.

The IRS challenged the values reported on their gift tax returns and said that the fair market value of the stock equaled the price used for actual share transactions between GBP and its employees and directors which were:

Gift Tax Year	**Price Per Share**
2007	$45.97

2008	$47.63
2009	$50.85

The IRS issued a notice of deficiency,and the Kresses paid the additional gift tax totaling more than $2 million. The Kresses then filed amended gift tax returns seeking a refund for the additional gift taxes and accrued interest they paid. When the IRS failed to respond, the Kresses initiated the lawsuit in 2016 to recover the gift tax and interest assessed.

After ruling on procedural matters involving the admissibility of certain evidence, the district court determined that the Kresses successfully shifted the burden of proof with respect to the valuation of the gifted shares by introducing credible evidence to support their position (including the testimony of two experts), maintaining credible records, and cooperating with the government's reasonable requests for documents and information. However, the court, citing Estate of Stuller v. United States, 55 F.Supp.3d 1091 (C.D. Ill. 2014) noted that if both parties had met their burdens of production by presenting some evidence, the party supported by the weight of the evidence will prevail regardless of which party bore the initial burden of production or persuasion.

The government used Francis Burns of Global Economics Group as its expert in the case. Burns determined the fair market value of the gifted shares using both a market approach and an income approach and ascribing a weight to each approach. Burns weighted the market approach 60 percent and the income approach 40 percent to determine the fair market value. This calculation resulted in the following valuations for the stock given to the children and grandchildren.

Gift Tax Year	**Price Per Share**
2007	$38.40
2008	$27.81
2009	$40.05

Under the market approach, Burns identified nineteen to twenty companies that were in the same business as GBP, eliminated companies based on dissimilar characteristics, and identified four comparable companies for each year.

Under the income approach, Burns completed a capitalized cash flow analysis.

Burns' marketability discounts were significantly below those of the expert witnesses of plaintiffs. Burns assessed marketability discounts of 10.8 percent, 11.0 percent and 11.2 percent nfor the respective tax years. The court found that Burns' discounts for lack of marketability were "unreasonably low."

The court also noted that Burns applied a separate subchapter S premium to his valuation. Both Burns' and plaintiffs' expert ,John Emory, applied C Corporation-level taxes to GBP's earnings to

compare GBP to other C Corporations. Burns then assessed a premium to account for the tax advantages associated with subchapter S status such as the elimination of the one level of taxes that GBP did not pay. Burns also noted that GBP did not pay C-corporation taxes in any of the valuation years and did not expect to in the future. Plaintiffs' experts, John Emory and Nancy Czaplinski, did not consider subchapter S status to be a benefit that would add to the value of the minority shareholder's stock because a minority shareholder could not change GBP's corporate status. The court believed that GBP's subchapter S status should have a neutral impact.

The court also found that Burns improperly treated the non-operating assets by adding back their full, undiscounted value after the discount analysis addressed above.

Plaintiffs' first expert, John Emory, had his own valuation firm. Burns solely relied on a market approach and applied minority and marketability discounts to arrive at the value of minority shares in GBP. He determined the value per share of the stock as follows:

Gift Tax Year	**Price Per Share**
2007	$28.00
2008	$25.90
2009	$21.60

The IRS criticized Emory's valuation for ignoring the income approach to valuation, so plaintiffs retained Czaplinski who worked at Duff & Phleps. Using the income approach, Czaplinski calculated the value of the stock for the relevant years to be:

Gift Tax Year	**Price Per Share**
2007	$30.87
2008	$25.92
2009	$25.06

The court found Emory's valuation methodology the most sound, noting that he derived values through interviewing management at GBP, reviewing prior year reports, and analyzing the most relevant guideline companies and the multiples they yielded.

The IRS also asserted that the Kresses' experts erred in considering the restriction of transfers between family members in the bylaws in calculating the lack of marketability discount. Generally, the valuation of any stock is determined without considering restrictions to sell the stock under section 2708. Plaintiffs maintained that the restriction meant all three requirements under section 2703A because it:

1. was a bona fide business arrangement;

2. was not a device to transfer property to members of the decedent's family for less than full and adequate consideration; and

3. included terms that are comparable to similar arrangements entered into by persons in arm's-length transactions.

The court agreed that plaintiffs had shown that the restriction was a bona fide business arrangement and was not a device to transfer property to members of the decedent's family for less than full and adequate consideration. However, the court found that the Kresses had not submitted specific evidence showing that the restriction was comparable to similar arrangements entered into by persons in an arm's-length transaction. Though Kresses contended that restrictions like the GBP family restrictions were common to the commercial world, they did not produce any evidence that unrelated parties dealing at arm's length would agree to such an arrangement.

The court did not fully accept Emory's discounts for lack of marketability. Instead, the court held that a 27 percent discount for lack of marketability for 2007 and 2008 and a 25 percent discount for lack of marketability for 2009 were more fitting. It noted that Emory's report only gave minimal consideration to the restrictions in the bylaws to transfers to family members, but that any consideration of that or other restriction was improper. As a result, a 3 percent downward adjustment was the appropriate. As a result, the value of the stock for give tax purposes was:

Gift Tax Year	Price Per Share
2007	$29.20
2008	$27.01
2009	$22.50

CHARITABLE GIFTS

26. Letter Ruling 201845014 (Issued August 9, 2018; Released November 9, 2018)

IRS issues favorable letter ruling with respect to two charitable remainder unitrusts

X intended to form two charitable remainder unitrusts. CRUT 1 was an inter vivos CRUT with X's life as the measuring life. CRUT 2 was an inter vivos CRUT with consecutive life interests in X and X's spouse, subject to X's right to revoke the spouse's survivor remainder interest. Each CRUT provided that the unitrust amount would be a percentage of the net fair market value of the trust property determined as of the first business day of the taxable year. Each CRUT also provided that the trustee would distribute to the private beneficiary (i) a fixed percentage of the unitrust amount and (ii) such additional portion of the unitrust amount as the independent trustee determined was necessary to ensure that the total portion of the unitrust amount distributed to the

private beneficiary in each taxable year was not de minimis under the facts and circumstances (the "minimum amount").

After providing for the distribution of the minimum amount to X or X's spouse, the trustee was to distribute the balance of the unitrust amount to such one or more of the private beneficiaries, and one or more charitable organizations in the "charitable class" as the independent trustee selected in equal or unequal portions in the independent trustee's sole discretion without the approval or consent of any other person. The charitable class, which would contain the permissible charitable distributees, consisted of such of one or more charitable organizations that X, as an individual and not as a fiduciary, designated by an instrument delivered to the independent trustee. The power to designate the members of the charitable class lapsed each year. X also retained the testamentary power to appoint the charitable organizations that would receive the remainder at the end of the unitrust term. A default charity was named to the extent that X did not exercise the testamentary power of appointment.

X retained the power to remove and appoint an independent trustee. When X ceased to act, X's wife was designated as the appointer and remover of the independent trustee.

The IRS was requested to give the following rulings:

1. The power of the independent trustee to allocate a portion of the unitrust amount between noncharitable and charitable beneficiaries would not prevent either CRUT from qualifying as a CRUT under Section 664.

2. The powers of X and X's wife to replace the independent trustee would not prevent either CRUT from qualifying as a qualified CRUT under Section 664.

3. The power of X to designate the charitable class of each trust would not prevent either CRUT from qualifying as a qualified CRUT under Section 664.

4. X's testamentary power to revoke the survivor remainder interest would not prevent CRUT 2 from qualifying as a qualified CRUT under Section 664.

5. X's power to designate the charitable class of each CRUT would prevent completion of the gift of the net unitrust amount during X's lifetime until the annual lapse of such power. Upon the annual lapse of X's power to designate the charitable class and to the extent each year that the net unitrust amount was distributed to one or more charitable organizations, the distributions would be completed gifts that would qualify for the gift tax charitable deduction.

6. X's testamentary power to revoke the survivor remainder interest in CRUT 2 would cause X's gift of the survivor remainder interest to remain incomplete until X's death.

7. With respect to CRUT 2, if X's spouse survived X and if X did not revoke the survivor remainder interest at X's death, the entire value of the assets of CRUT 2

included in X's estate would be deductible because of the combined charitable and marital estate tax deductions.

The Service first ruled that the provisions in each CRUT giving the independent trustee the power to allocate a portion of the unitrust amount between charitable and noncharitable beneficiaries would not prevent either CRUT from qualifying as a valid CRUT under Section 664. The IRS noted that Section 674(c) provides an exception to the general rule of Section 674(a) under which the power of an independent trustee to allocate the unitrust amount among charitable and noncharitable beneficiaries on an annual basis is consistent with the provisions of the Internal Revenue Code governing charitable remainder trusts. The governing instrument must require that a portion of the unitrust amount be allocated and paid to the noncharitable beneficiaries each year and that amount must be not de minimis.

The Service next concluded that the retained powers of X and X's wife to remove and appoint the independent trustee would not allow them to substitute any person who would be subordinate to X or X's wife. Consequently, these powers to remove and replace the independent trustee would not prevent either CRUT from qualifying as a valid CRUT under Section 664.

The Service next ruled that X's power to designate the charitable class of each CRUT would not prevent either CRUT from qualifying as a valid CRUT under Section 664. In addition, X's testamentary power to revoke the survivor remainder in CRUT 2 would not prevent CRUT 2 from qualifying under Section 664.

The Service then ruled that X's annual power to designate the charitable class would prevent completion of the gift of the net unitrust amount of each CRUT during X's lifetime until the lapse of such power. Upon the annual lapse of X's power to designate the charitable class and to the extent each year that the net unitrust amount was distributed to one or more charitable organizations, the distributions would be completed gifts and would qualify for the gift tax charitable deduction. In addition, the retention of the power to revoke the survivor remainder in CRUT 2 would cause X's gift of the survivor remainder to remain incomplete until X's death. At X's death, the property remaining in CRUT 2 would not be subject to estate tax because it would qualify either for the marital deduction or the charitable deduction.

27. **Wendell Falls Development, LLC v. Commissioner, T.C. Memo 2018-45; motion for reconsideration denied, T.C. Memo 2018-193**

No charitable contribution deduction is allowed for the donation of a conservation easement and no penalty is applicable

The IRS disallowed an income tax charitable contribution deduction of $1,798,000 for the contribution of a conservation easement by Wendell Falls LLC. The IRS also sought to impose a 40 percent penalty for a gross valuation misstatement or, in the alternative, a 20 percent penalty for a substantial valuation misstatement. Wendell Falls, as part of a planned unit development in Wake County, North Carolina, intended to develop 1,280 acres. It also identified 125 acres of the 1,280 acres as the land upon which a park would be placed. In late 2006, the Wake County Board of Commissioners authorized the county to buy the 125 acres identified on the map as a park.

Because of an incorrect reference in the planned unit development to the park having 160 acres as opposed to 125 acres, the purchase agreement inadvertently stated that the acreage of the planned park was 160 acres. The purchase agreement also stated that placing a mutually agreeable conservation easement on the land was a precondition to the sale. After realizing the mistake and having a new appraisal done, the land was valued at $3,020,000 unrestricted by any conservation easement and the Wake County Board of Commissioners reauthorized the purchase. On June 7, 2007, a conversation easement on the 125 acres was placed on the property and subsequently a general warranty deed was recorded transferring ownership of the 125 acres from Wendell Falls to Wake County.

On its partnership return for 2007, Wendell Falls claimed a charitable contribution deduction of $1,798,000 for the contribution of the conservation easement. The value of the conservation easement, according to the appraiser, was $4,818,000, and $1,798,000 represented the difference between the appraised value and the price paid by Wake County. The court denied the charitable contribution deduction for the easement for two reasons. The first was that Wendell Falls expected a substantial benefit from the conservation easement. The evidence showed that Wendell Falls would benefit from the increased value in the lots to be sold in the planned unit development from having the park as an amenity. Consequently, Wendell Falls donated the easement with the expectation of receiving a substantial benefit. The court held that the charitable contribution deduction was not allowable because of the expectation of the substantial benefit.

Alternatively, the value of the easement was zero. An easement must have value to generate a charitable contribution deduction. In order to determine the value because there were no sales of easements comparable to the easement contributed by Wendell Falls, the value of the easement would be equal to the value of the land before the easement minus the value of the land after the easement. In looking at the plan developed by Wendell Falls which had owned the entire 1,280 acres including the 125 acres, the best use of the 125 acres was as a park in the midst of a master planned community. The conservation easement did not diminish the value of the 125 acres because it was not prevented from being put to its best use. As a result, the value of the easement was zero.

After trial, the IRS conceded that the 40 percent penalty for gross valuation misstatement did not apply. The court rejected the imposition of the 20 percent penalty because Wendell Falls LLC had acted in good faith since it had hired two different state-certified real estate appraiser to value the conservation easement.

28. **Champions Retreat Golf Founders, LLC v. Commissioner**, T.C. Memo 2018-146

Golf club development was not entitled to charitable deduction for donation to land trust of conservation easement operating across golf course

Champions Retreat received a 463.3-acre tract to build a golf course in 2002. Champions Retreat raised an initial $13.2 million for construction of the golf club by selling 66 residential lots and borrowing heavily in order to complete construction of the golf club which occurred in June 2005. The golf club accounted for 363.56 acres of the 463.3-acre tract. After completion, Champions

Retreat was not profitable. On December 16, 2010, Champions Retreat conveyed an easement that covered 348.51 acres to North American Land Trust. Champions Retreat claimed a $10,427,435 income tax charitable deduction on its partnership income tax return for 2010.

The easement identified three conservation purposes:

1. Preservation of the area as a relatively natural habitat of fish, wildlife, or plants or similar ecosystems;

2. Preservation of the area as an open space which provided scenic enjoyment to the general public and yielded a significant public benefit; and

3. Preservation of the area as an open space which, if preserved, would advance a clearly delineated federal, state, or local governmental conservation policy and would yield a significant public benefit.

The court observed that the easement area included 25 of the 27 holes in their entirety, most of the two remaining holes, and the driving range.

On audit, the IRS denied the income tax deduction on two alternative grounds. The first was that the conservation easement did not meet the requirements of Section 170. The second was that the easement did not have a value greater than zero.

The court only addressed the first ground advanced by the IRS. The court was unpersuaded that there was a sufficient presence of rare, unchanged, or threatened bird species in the easement area. In addition, the denseflower knotweed, which is a rare, endangered, or threatened species, only occupied a small fraction of the easement area.

Thus, a habitat for rare, endangered, or threatened species of animals, fish, or plants was not provided.

The court also concluded that the easement area was not a natural area that contributed to the ecological viability of the Sumter National Forest, which lies across the Savannah River from the easement area.

The easement area did not meet the test for providing open space because of the limited physical access of the public to view the easement area from the Little and Savannah Rivers which was further limited by three to ten foot river banks.

Finally, Champion Retreats' preservation of open space was neither for the enjoyment of the general public nor pursuant to a clearly delineated government policy. Thus, it could not provide a significant public benefit.

29. **<u>Belair Woods, LLC v. Commissioner</u>, T.C. Memo 2018 - 159**

On cross motions for partial summary judgment, court concludes that Belair did not comply, either strictly or substantially, with the requirements of the regulations with

respect to obtaining an income tax charitable deduction; however, disputes of material fact existed as to whether Belair had reasonable cause for failure to supply a fully completed appraisal summary

This case was decided on cross motions for partial summary judgment. Belair was formed in the late 2008 as a Georgia limited liability company. On December 18, 2008, HRH Investments LLC contributed 145.15 acres of real estate to Belair. On December 30, 2009, Belair entered into a deed of conservation easement with the Georgia Land Trust and the deed was recorded the next day. Belair delegated many details regarding this transaction to Forever Forests, LLC. Forever Forests was a consulting firm specializing in structuring conservation easements to maximize the tax benefits for donors. Forever Forests advised Belair on the terms of easement as well as the tax filings with respect thereto.

Belair timely filed the partnership return and claimed an income tax charitable contribution deduction of $4,778,000 for the donation of the easement. Belair included with the return a copy of an appraisal that relied on the "before and after" method to value the easement. Belair also included with its return a Form 8283 executed by the appraiser and the Georgia Land Trust. The instructions to Form 8283 directed the taxpayer to provide the IRS with certain information regarding non-cash charitable contributions. When a taxpayer donates property (other than publicly traded securities) valued in excess of $5,000, the taxpayer must provide:

1. A description of the donated property;
2. A brief summary of its physical condition;
3. Its appraised fair market value;
4. The date the property was acquired by the donor;
5. The manner of acquisition; and
6. The donor's cost or adjusted basis.

The instructions to the Form 8283 also state that "[I]f you have reasonable cause for not providing the information. . .attach an explanation so your deduction will not automatically be disallowed."

Belair contacted Forever Forests about preparing the Form 8283, specifically with reference to reporting its "cost or adjusted basis," since it was using the "before and after" method to value the easement. Forever Forests relayed advice it had received in 2008 from the Baker Donelson law firm. At the request of Forever Forests, an attorney at that firm had reviewed the instructions to the Form 8283 and concluded that it should not be necessary to include the basis information if an explanation is attached to the Form 8283 providing reasonable cause why the basic information was not included. The attorney also stated that a reasonable cause for not including basis information should be that the basis of the property was not taken into consideration when computing the amount of the deduction.

When it filed the Form 8283, Belair appended a two-page letter which stated that a declaration of the taxpayer's basis in the property was not included because the basis of the property was not taken into consideration in computing the amount of the deduction.

The IRS audited Belair's 2009 return and issued a summary report explaining that Belair's claimed deduction should be disallowed because Belair did not include information concerning the cost of the easement or adjusted basis on the Form 8283. About one month later, Belair's CPA responded to the summary report and provided cost basis information concerning the easement.

On June 19, 2017, the IRS disallowed the deduction because the requirements of Section 170 had not been met. Alternatively, the IRS determined that no kind of deduction was allowable because Belair had not established the fair market value of the easement. The IRS also proposed a 40 percent gross valuation misstatement penalty or, in the alternative, a 20 percent accuracy related penalty. Both Belair and the IRS agreed that Treas. Reg. § 1.170A-13(c)(2)(i)(B) requires a donor to attach a fully completed appraisal summary to the tax return on which the charitable contribution deduction is first claimed. The tax deduction will not be disallowed simply because of the inability (for reasonable cause) to provide certain information.

The Tax Court concluded that Belair did not strictly comply with the regulatory requirements because it did not report its cost basis as the regulation requires and as Form 8283 directed. Moreover, the explanation that Belair attached to that form, far from showing its inability to provide the information, simply asserted that the information was unnecessary. Belair contended that it had reasonable cause for omitting the basis information because it did not know what basis to report. The court noted that even if Belair's premise was correct, the conclusion did not follow from its premise. The regulations exclude the admission of basis information only if a reasonable cause is established and the explanation is attached to the appraisal.

Belair alternatively contended that it cured its initial omission by supplying cost basis information during the audit with the IRS. Treas. Reg. § 1.170A-13 (c)(4)(iv)(H) provides that a deduction will not be disallowed for failure to attach an appraisal summary if the donor complies with IRS instructions to submit that document within 90 days of an IRS request therefor. Belair argued that this regulation entitled it to relief because its CPA provided basis information to the IRS in January 2013 shortly after being notified that Belair's deduction would be denied for failure to submit a properly completed Form 8283. The court said that the regulation did not apply in this situation. Belair did not fail to attach an appraisal summary. Rather Belair intentionally included an incomplete Form 8283 with its return.

The court also rejected Belair's argument that it had substantially complied with the regulation. Relying upon <u>RERI Holdings</u> 1, 149 T.C. ___ (July 3, 2017), the court concluded that a taxpayer did not substantially comply with a reporting requirements when it failed to disclose cost or adjusted basis on the Form 8283. However, Belair contended that when preparing its Form 8283, it reasonably relied on advice from Forever Forests, which in turn relied on advice from an outside law firm. The court concluded that the resolution of this issue could require it to address several questions as to which genuine disputes of material fact currently appeared to exist. These questions included whether Forever Forests was a tax professional, whether Forever Forests was a competent and independent advisor unburdened with a conflict of interest, whether Belair could reasonably

rely on legal advice relayed to it indirectly and whether Belair actually relied in good faith on advice that the IRS seemed to regard as too good to be true. As a result, the court denied Belair's motion for partial summary judgment and granted in part and denied in part the IRS's motion for partial summary judgment.

30. **Notice 2017-73, 2017-51 IRB 562 (December 4, 2017)**

IRS describes approaches being considered to address certain issues regarding Donor Advised Funds

This notice describes approaches that the Treasury Department and the Internal Revenue Service are considering to address certain issues regarding Donor Advised Funds. Specifically, the Treasury Department and the IRS are considering developing proposed regulations that would provide that certain distributions from a Donor Advised Fund that paid for the purchase of tickets that enable a Donor, Donor advisor, or related person to attend or participate in a charity-sponsored event do not result in more than an incidental benefit to such person. The Treasury Department and the IRS are also considering proposed regulations that distributions from a Donor Advised Fund that the distributee charity treats as fulfilling a pledge made by a donor, a donor advisor, or related person do not result in more than an incidental benefit if certain requirements are met. The Treasury Department and the IRS are also considering developing proposed regulations that would change the public support computation for organizations to prevent the use of Donor Advised Funds to circumvent the excise taxes applicable to private foundations. The notice requests comments regarding the issues addressed.

If regulations are issued as described in this notice, a beneficial development is that a Donor Advised Fund will be able to pay pledges, whether legally binding or not, made by the Donor of the Donor Advised Fund. Previously, the implications of satisfying a pledge with a grant from a Donor Advised Fund were unknown. One commentator has described the proposed IRS policy as "don't ask, don't tell."

GENERATION-SKIPPING TRANSFER TAX

31. **Letter Rulings 201820007 and 201820008 (Issued February 5, 2018; Released May 18, 2018)**

Proposed distribution from one generation-skipping tax exempt trust to another exempt trust will not cause either trust to lose their exempt status

These letter rulings concern irrevocable GST exempt trusts created after September 25, 1985. Separate trusts were established with identical terms for the benefit of the Settlor's two sons. Trust A was an irrevocable trust for the benefit of one son and Trust B was an irrevocable trust for the benefit of a second son.

The trustee could currently distribute income and principal to each son for the son's support, maintenance, education, and health. Upon the death of the son, the son had a limited testamentary power of appointment to the issue of the Settlor. Otherwise the property passed per stirpes to the son's then living issue.

Trustee subsequently appointed all the principal and accumulated income of one of the trusts to a new trust, known as Trust C. During the son's lifetime, the distribution standard and trustee were the same as the distribution standard and trustee in Trust A. The son continued to have a testamentary limited power of appointment to the settlor's issue. However, Trust C expressly provided that the son could create a new trust for the benefit of permissible appointees. The beneficiary of each new trust was given a testamentary general power of appointment which would cause the assets of the trust to be included in the estate of the beneficiary at his or her death. Consequently, the distribution of property from Trust A to Trust C would not cause a shift to beneficial interest to lower generation or extend the time for vesting of any beneficial interest.

As a result, the proposed appointment from Trust A to Trust C would not cause the trust to lose its exempt status for GST purposes because the new trust satisfied the requirements of Treas. Reg. § 26.2601-1(b)(4)(i)(D) since the change would not shift any beneficial interest to a lower generation and would not extend the term of the trust beyond the period permitted in the original trust.

32. **Letter Ruling 201815012 (Issued November 14, 2017; Released April 13, 2018)**

Extension of time granted to allocate spouse's available GST exemption

Decedent while alive established an irrevocable trust for the benefit of decedent's children and their descendants. Decedent died survived by spouse and children. An accountant prepared the gift tax returns for the transfer to the trust and decedent's spouse elected to split gifts on the gift tax return. However, the CPA failed to allocate any GST exemption to the initial transfer to the trust. The error was discovered later when an attorney discovered that no GST exemption had been allocated to the transfer of the trust on the gift tax return. The spouse had sufficient GST exemption that year to completely exempt the trust from GST Tax and requested an extension of time to do so.

The Service ruled that under Section 2642(g)(1)(A) and Treas. Regs. §§ 301.9100-1 and 301.9100-3, an extension of time should be granted. The two regulations provide that an extension of time will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional to make the election.

33. **Letter Ruling 201801001 (Issued September 20, 2017; Released January 5, 2018)**

Estate granted an extension of time to allocate GST exemption

When Decedent died, the residue of his estate passed to Trust 1. Trust 1, in turn, created an irrevocable sub-trust, Trust 2, for the benefit of Decedent's spouse and issue. An attorney prepared the Form 706; however, the attorney failed to allocate GST exemption to Trust 2.

The error was discovered subsequently when the surviving spouse and a son consulted a second attorney regarding the family estate planning and discovered that the GST exemption had not been allocated to Trust 2 on the Form 706. They then requested an extension of time to allocate GST exemption to Trust 2. Under Treas. Reg. § 301.9100-3, an extension of time will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. The regulation provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election. The Service found that the requirements of Treas. Reg. § 9100-3 had been met and the request for an extension of time to allocate GST exemption was granted.

34. Letter Rulings 201803001 and 201803002 (Issued September 18, 2017; Released January 19, 2018)

Extension of time to allocate GST exemption granted

In these companion letter rulings, Donor established an irrevocable trust for the benefit of his child. Although the trust had GST potential, a portion of the trust had the potential to be included in the gross estate of a non-skip person other than the transferor if such person died immediately after the transfer. Donor retained an accountant and an attorney for advice on reporting the transfers and preparing the necessary Form 709. At all times, Donor indicated his intention that the trust be exempt from GST tax.

Accountant prepared a Form 709, on which Donor reported his transfers to the trust. However, in preparing the Form 709, his accountant failed to allocate GST exemption to the transfer to the trust. No Forms 709 were prepared for the thirteen subsequent years in which Donor made transfers to the trust based on the accountant's and attorney's advice that filing Forms 709 was unnecessary. At the time the error was discovered, Donor had sufficient GST exemption to allocate to the transfers. Donor requested an extension of time to allocate GST exemption to the transfers to the trust in years 1 through 3 and to treat the trust as a GST trust with respect to all transfers made by Donor to the trust.

Treas. Reg. § 301.9100-3 provides that an extension of time to make an election may be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election. The IRS found that the requirements of the regulation had been satisfied and granted an extension of time to allocate GST exemption to the gifts made in the first three years. In addition, Donor was granted an extension of time to treat the trust as a GST trust with respect to the transfers to the trusts in the fourth year and all subsequent transfers. That would cause the automatic allocation of Donor's unused GST exemption to the trust in those years.

35. Letter Ruling 201840002 (Issued July 2, 2018; Released October 5, 2018)

Grantor granted extension of time to allocate GST exemption to trust

Grantor created two irrevocable trusts for the benefit of grantor's descendants. An accounting firm prepared the gift tax returns. However, the grantor failed to allocate any of grantor's GST exemption to the transfers to the two trusts. The error was discovered in year two when a newly hired attorney was added to the grantor's advisory team at the law firm and the attorney discovered that no GST exemption had been allocated to the transfers to the two trusts on the gift tax return. The grantor requested an extension of time to allocate GST exemption.

The Service granted the request for an extension of time to allocate GST exemption. Treas. Reg. § 301.9100-3 provides that requests for an extension of time will be granted when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

36. Letter Ruling 201839001 (Issued June 18, 2018; Released September 28, 2018)

Extension of time to allocate GST exemption granted

Settlor created an irrevocable charitable lead unitrust for the benefit of a foundation and the settlor's grandchildren. The settlor and his spouse agreed to split the gifts. The settlor engaged an accounting firm to prepare the gift tax returns for the settlor and the spouse. The gift tax returns did not allocate any of the settlor's or spouse's GST exemption to the trust. The error was discovered when the settlor's current tax advisor reviewed the trust agreement and the gift tax returns. Each of the settlor, the spouse, and the accounting firm signed affidavits stating that the settlor and spouse intended to allocate their available GST exemption to the trust.

The settlor and the spouse requested an extension of time to allocate their respective GST exemptions to the charitable lead unitrust. The Service granted the request for an extension of time to allocate GST exemption. Treas. Reg. § 301.9100-3 permits the granting of requests for relief when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied upon a qualified tax professional and the tax professional failed to make or advise the taxpayer to make an election.

37. Letter Rulings 201849007 and 201849008 (Issued July 31, 2018; Released December 7, 2018)

IRS grants an extension of time for grantors to allocate GST exemption to trust

Grantors created a trust for the benefit of their issue. An accountant prepared and filed the gift tax returns for Grantor 2's gifts to Trust 1 and Trust 2 in which Grantor 2 and spouse elected to split

the gift under Section 2513. Accountant failed to allocate Grantor 2 and spouse's respective GST exemptions to the transfers to the trusts on two dates. Grantor 2 and spouse requested an extension of time pursuant to Treas. Reg. §§ 301.9100-1 and 301.9100-3 to allocate their GST exemptions to the transfers to the trusts on the two dates.

The Service granted the request for an extension of time because the requirements of Treas. Reg. § 301.9100-3 had been satisfied. Requests for relief will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional to make the election.

38. **Letter Ruling 201850010 (Issued September 17, 2018; Released December 14, 2018)**

IRS grants extension of time to sever QTIP trust into exempt and non-exempt QTIP trusts and to make a "reverse" QTIP election for the exempt QTIP trust and to apply the GST automatic allocation rules to allocate GST exemption to the exempt QTIP trust

Decedent died survived by spouse. Decedent's revocable trust, which contained the provisions for the disposition of decedent's assets after his death, provided that if spouse survived decedent, the trustee was to divide the trust into a QTIP marital trust and a bypass trust. Moreover, if the property allocated to the QTIP martial trust exceeded decedent's available GST tax exemption allocated to that trust, the trustee was to establish exempt and non-exempt QTIP trusts.

Upon decedent's death, decedent's estate retained a law firm to prepare the estate tax return. The estate made the QTIP election for the QTIP trust to qualify it for the estate tax marital deduction. However, the Form 706 prepared by the law firm failed to indicate that the QTIP trust was to be severed into exempt and non-exempt QTIP trusts and did not make a reverse QTIP election with respect to the exempt QTIP trust. As a result, none of decedent's GST exemption was allocated to the QTIP trust.

The law firm did not advise the estate of the need to sever the QTIP trust, make a reverse QTIP election, or apply GST exemption to the exempt QTIP trust. These errors were only discovered after the spouse's death.

The Service granted an extension of time to sever the QTIP trust into exempt and non-exempt QTIP trusts and to make a reverse QTIP election with respect to the exempt trust. It also ruled that the automatic allocation rules would automatically allocate decedent's unused GST exemption to the exempt QTIP trust as of the date of decedent's death.

These rulings were issued pursuant to Treas. Reg. §§ 301.9100-1 and 301.9100-3 which provide that an extension of time will be granted when the taxpayer establishes that the taxpayers acted reasonably and in good faith and the grant of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer relied

on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

39. Letter Rulings 201839003 (Issued June 18, 2018; Released September 28, 2018), and 201839012, and 201839014 (Issued June 21, 2018; Released September 28, 2018)

Extension of time granted to opt out of automatic allocation rules

Taxpayer established an irrevocable grantor retained annuity trust. Taxpayer and spouse each filed a gift tax return and consented to have the transfers to the grantor retained annuity trust as having been made one-half by each spouse. Each trust had GST potential.

An accountant was responsible for preparing the gift tax returns for the taxpayer and spouse. The accountant failed to advise the taxpayer and spouse that it was necessary to file a gift tax return for the second year to opt out of an automatic allocation of GST exemption when the estate tax inclusion period (ETIP) ended. The spouse or the taxpayer in these rulings requested an extension of time to opt out of the automatic allocation rules.

The IRS granted the request of the taxpayer and the spouse. Treas. Reg. § 301.9100-3 provides that requests for relief will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government. The taxpayer is deemed to have acted reasonably and in good faith of the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

40. Letter Rulings 201836004 and 201836007 (Issued June 5, 2018; Released September 7, 2018)

Spouse's allocation of GST exemption to three trusts was void under Treas. Reg. § 26.2632-1(b)(4)(i) because trusts had no GST potential with respect to spouse

Taxpayer established three irrevocable trusts for the primary benefit of his three children respectively. The terms of each trust provided for discretionary distributions of income for the health, education, and support of each child. Upon the death of the second to die of taxpayer and spouse, the trustee could make discretionary distributions of principal for the health, education, and support of the child. The child had the right to withdraw the principal of the trust at four different ages. Each trust granted the child a testamentary general power of appointment to the child's estate, the creditors of the child's estate, or to any person or corporation.

The taxpayer made gifts to the trust in year 1 and year 2. The taxpayer and spouse each filed a gift tax return. On each form, the taxpayer and spouse signified their consent to treat each transfer as having been made one-half by each spouse under section 2513. On each gift tax return, taxpayer and spouse erroneously allocated GST exemption to the transfers to the three trusts.

The taxpayer and the spouse requested rulings that the allocations of GST exemption made to the three trusts were void because there was no GST potential with respect to those transfers.

The Service found that the trust had no GST potential with respect to the taxpayer or the spouse. The child was the primary beneficiary of each trust. The trustee was only authorized to make distributions of income and principal to the child. The child could withdraw amounts of principal from the trust upon reaching different ages. None of the payments were payments to skip persons and therefore, none were generation-skipping transfers with respect to the taxpayer or the spouse. Upon the child's death, the child had a testamentary general power of appointment, which would cause the property in the trust to be included in the child's estate. As a consequence, the child would be the transferor of any payments made from the trust after the death of the child. Consequently, because there was no GST potential, the taxpayer and the spouse's allocation of GST exemption to the trust was void under Treas. Reg. § 26.2632-1(b)(4)(i). This regulation provides that an allocation of GST exemption to a trust is void to the extent that the amount allocated exceeds the amount necessary to obtain an inclusion ratio of zero with respect to the trust. An allocation is also void if the allocation is made with respect to a trust that has no GST potential with respect to the transferor making the allocation at the time of the allocation.

41. **Letter Rulings 201811002 and 201811003 (Issued November 27, 2017; Released March 16, 2018)**

Service rules on application of split-gift rules to the allocation of GST exemption

These two rulings dealt with the same transaction. Husband created four irrevocable trusts, one for each of his four children of which each child was the primary beneficiary. Upon each child's death, the principal was to be held in further trust and distributed outright to the child's children upon those children obtaining age 35. An accounting firm prepared the gift tax returns for husband and wife. Husband and wife consented to treat the gifts as being split between them. However, husband's gift tax return reported his portion of the total transfer to the trust to be 3/4 (rather than 1/2) of the amount actually transferred to the trust. Wife's gift tax return reported her portion of the total transfer to the trust to be 1/4 (rather than 1/2) of the amount transferred to the trust. No amount of either husband's or wife's available GST exemption was allocated to the transfers on the gift tax returns.

Several years later, after discovering the error, the accounting firm advised husband of the ability to make a late allocation of GST exemption to the trust. The accounting firm prepared husband's new gift tax return to include the late allocation of GST exemption to the original transfers to the trust. The late allocation of husband's GST exemption erroneously allocated an amount equal to 100% of the value of the initial transfers to the trust with such value determined as of the effective date of the allocation. The notice of allocation attached to the new gift tax return stated that, as a result of the late allocation, the inclusion ratio of the trust was zero. Wife was not advised to make a late allocation of GST exemption to wife's portion of the initial transfers to the trust.

A ruling was requested that because the period for the assessment of gift tax had expired, the husband was to be treated as the transferor of the amount reported for husband's portion of the initial transfers on the initial gift tax return. In addition, rulings were also requested that the wife was to be treated as the transferor of the amount reported for wife's portion of the initial transfers to the trust on wife's initial gift tax return and that an extension of time would be granted to wife's

estate to make a timely allocation of GST exemption to wife's portion of the initial transfers to the trust.

The Service ruled that because the time had expired under Section 6501 as to when a gift tax may be assessed, the husband was treated as having transferred 3/4 of the total amount to the trust and wife was treated as having transferred 1/4 for gift tax purposes.

However, under Treas. Reg. § 26.2652-1(a)(4), husband is regarded for generation-skipping tax purposes as the transferor of 1/2 of the total value of the property transferred to the trust regardless of the interest that husband was treated as having transferred for gift tax purposes. As a result, husband's late allocation of the GST exemption to the trust on the Form 709 was effective only to 1/2 of the property transferred to the trust. The Service granted the request of wife's estate for an extension of time to allocate GST exemption to the trust for her portion. It found that the requirements of Treas. Reg. § 9100-3 had been met. Under this regulation, requests for relief will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith when the taxpayer reasonably relied on a qualified tax professional. Wife's GST exemption would be allocated to 1/2 of the transferred property and the allocation would effective as to the date of the transfer to the trust.

42. **Letter Rulings 201814001 and 201814002 (Issued December 11, 2017; Released April 6, 2018)**

Construction of ambiguous terms of grandfathered GST trust will have no adverse generation-skipping tax, gift tax, or income tax consequences

Settlor established an irrevocable trust for the benefit of his lineal descendants prior to September 25, 1985. Consequently, the trust was grandfathered from the GST tax. The current trustees of the trust were child, individual, and a bank. The terms of the trust were ambiguous. However, Settlor was currently living at the time of the ruling request and attested that at the time the trust was created and all times thereafter, Settlor intended for the trust only to benefit blood descendants. The trustees petitioned the State Court for declaratory judgments construing the ambiguous terms of the trust consistent with Settlor's intent to benefit only blood descendants and the State Court entered that order conditioned upon the trustees obtaining a favorable ruling by the Internal Revenue Service that the order would have no adverse generation-skipping tax, gift tax or income tax consequences.

The Service first ruled that the terms of the trust presented a bona fide issue regarding whether an adopted grandchild of the Settlor was considered a member of the class of issue, descendants, or children. It also ruled that the State Court's order construing the ambiguous terms was consistent with the applicable state law that would be applied by the highest court of the state. The Service here followed Treas. Reg. § 26.2601-1(b)(4)(i)(C) which provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument to correct a scrivener's error will not cause an exempt trust to be subject to the generation skipping tax if the judicial action involves a bona fide issue and the construction is consistent with the applicable state law that would be applied by the highest court of the state, pursuant to Commissioner v. Estate of Bosch,

387 U.S. 456 (1967). Here the declaratory judgment met the requirements of the Treasury regulations and the construction of the trusts would not affect its exempt status.

Next, the Service ruled that because the State Court's order clarified the ambiguous terms at issue, the order construing the ambiguous terms was not a transfer for gift tax purposes and was not a taxable gift pursuant to Section 2501. Finally, the Service ruled that because the State Court's order resolved an ambiguity as to the construction of the trust and carried out the intent of the Settlor rather than resulting in a disposition of the interest of the trust, there would be no realization of gain or loss to the trust for income tax purposes.

43. Letter Ruling 201818005 (Issued January 16, 2018; Released May 4, 2018)

Partition of trust in accordance with terms of partition order will have no adverse income, gift, or generation-skipping tax consequences

Grantor created a trust prior to September 25, 1985. Consequently, the trust was grandfathered from GST tax. The trust was created for the primary benefit of daughter, four grandchildren, and four great grandchildren. In a previous partition proceeding, the trust was divided along the family line into five separate trusts. In the ruling addressing that partition, the Service ruled that the first partition order would not cause the trust to realize gain or loss from any sale or disposition; would not result in a transfer by any beneficiary of the trust subject to the gift tax; and would not cause distributions from the trust to be subject to GST tax.

This later ruling request applied only to one of the five trusts. This trust was for the benefit of one granddaughter who had five living children. In the second partition order, the court modified the granddaughter's trust to provide that upon the death of the granddaughter, her trust would be equally divided or partitioned into separate trusts for the benefit of each living child of that granddaughter and for the benefit of each group comprised of the living descendants of a deceased child of the granddaughter per stirpes. The Service ruled that the modification of the granddaughter's trust would not be considered an exchange of property resulting in the realization of gain or loss. This was because there would be no material difference in the positions of the beneficiaries of the trust before and after the partition. In addition, there would be no adverse gift tax consequences.

With respect to the GST tax, the Service ruled that the fact pattern in this letter ruling was similar to Treas. Reg. § 26.2601-1(b)(4)(i)(E), Example 5. In that example, the Service stated that the division of a grandfathered irrevocable trust for the benefit of two children and their issue would not have adverse GST tax consequences upon a court-approved division of the trust into two equal trusts, one for the benefit of each child and his or her issue. This is because the division of the trust did not shift any beneficial interest in the trust to a beneficiary in a lower generation. In addition, the division would not extend the time for vesting of any beneficial interest in the trust beyond a period provided for in the original trust. Essentially the same fact pattern as in Example 5 applied here and the Service ruled that there were no adverse generation-skipping tax consequences.

44. Letter Ruling 201825007 (Issued March 15, 2018; Released June 22, 2018)

Modification of GST grandfathered trust will not affect exempt status

Decedent created a trust for the benefit of his daughter and her descendants through his will. Decedent died prior to December 26, 1985 and the trust was grandfathered from GST tax. The trust was initially administered in State A. The court in State A issued a final order modifying the method of determining the income of the trust. Under the modification, the trustees were to distribute an amount equal to the greater of the trust's annual net income or X percent of the total value of the trust determined on the first date of each year. This was done pursuant to a statute in State A. This order was contingent on the receipt of a favorable ruling from the IRS.

Subsequently, the situs of the trust was moved to State B. The corporate trustee now sought to modify the method for determining the trust income. Under the proposal, the annual distribution amount to be paid by the trustees would be a unitrust amount. The trustee also sought an ordering rule for determining the character of the annual trust distributions for income tax purposes in accordance with the State B's statute. In all other respects, the terms of the trust would be identical to the original trust.

In general, a modification of the governing instrument of an exempt trust will not cause an exempt trust to be subject to the GST tax if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who currently are the beneficiaries and the modification does not extend the time for vesting any beneficial interest in the trust beyond the period provided for in the original trust. See Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1). Based on examples in the treasury regulations, the IRS ruled that the proposed changes would not shift a beneficial interest to a beneficiary in a lower generation and would not extend the time for the vesting of any beneficial interest beyond the period provided for in the original trust. As a result, the modification of the method of determining trust income and the adoption of the ordering rule would not cause the trust to lose its GST exempt status.

45. Letter Ruling 201825023 (Issued March 9, 2018; Released June 22, 2018)

IRS grants decedent's estate an extension of time to sever a residuary trust into an exempt and non-exempt residuary trust

Upon decedent's death, the residue of decedent's revocable trust was to be held in a residuary trust that had GST tax potential. In addition, one paragraph of the trust directed the trustee to divide any trust into two separate sub trusts of equal or unequal value whenever the division was necessary or desirable to minimize transfer or other taxes. Finally, the trust provided that the trust should be construed in a matter consistent with decedent's objective of using all available GST tax exemptions and to have trusts that were either entirely exempt or entirely non-exempt.

The executors engaged a law firm to prepare a Form 706. An accounting firm was retained to advise the estate on income tax issues arising as a result of decedent's death. Neither the law firm

nor the accounting firm advised decedent's estate of any gifts or distributions to grandchildren that would have a GST impact. Moreover decedent's estate was not advised to divide the residuary trust into separate exempt and non-exempt trusts to effect decedent's GST planning. The estate tax return was timely filed but did not evidence any attempt to divide the residuary trusts into exempt or non-exempt trusts. The executors requested an extension of time to sever the residuary trust into exempt and non-exempt trusts and a ruling that the automatic allocation rules would cause any unused portion of decedent's GST exemption to be allocated to the exempt residuary trust.

Treas. Reg. § 26.2654-1(b)(1)(ii) provides that the severance of a trust that is included in the transferor's gross estate into two or more trusts will be recognized for generation-skipping tax purposes if the trust is severed pursuant to discretionary authority granted either under the governing instrument or under local law. The terms of the new trust must provide for the same succession of interests and beneficiaries as provided in the original trust. The severance needs to occur prior to the date prescribed for filing the federal estate tax return for the estate of the transferor. The severance must occur on either a fractional basis or if a pecuniary basis severance is required, it meets the requirements for payments to individuals.

Based upon the facts submitted, the IRS concluded that the requirements of Treas. Reg. § 301.9100-3 were satisfied. This regulation provides that requests for relief will be granted when the taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer.

FIDUCIARY INCOME TAX

46. Letter Ruling 201807001 (Issued November 13, 2017; Released February 16, 2018)

IRS recognizes reformation of trust to qualify as a grantor trust for income tax purposes

Donor created a trust which he intended to be a grantor trust prior to August 20, 1996. The Donor was not a citizen of the United States. At the time Donor executed the trust, he was not married and had no issue. Subsequently, Donor married and had issue. None of Donor, Donor's spouse, and Donor's issue were ever United States citizens.

The trust, as originally drafted, provided that the independent trustee during the lifetime of Donor, could distribute the income and principal of the trust to or for the benefit of Donor and Donor's issue.

Prior to August 20, 1996, the trust was treated as a grantor trust for income tax purposes; however, as a result of the Small Business Job Protection Act in 1996, which became effective on August 20, 1996, the grantor trust rules only apply in computing the income of a citizen or resident of the United States. There was an exception that provides that a trust would be treated as a grantor trust

if during the lifetime of the grantor distributions could only be made to a non-citizen grantor or the non-citizen spouse. As a result of the Small Business Job Protection Act, after August 20, 1996, the trust was no longer a grantor trust.

The grantor filed a reformation suit to eliminate the issue as beneficiaries of the trust so that the trust could be treated as a grantor trust for income tax purposes. The grantor and the attorney who drafted the trust testified that Donor always intended the trust to be a grantor trust from its inception and the court granted the request for reformation and the issue were eliminated as beneficiaries.

The IRS held that the transcripts and representations of the party showed that Donor intended that the trust be a grantor trust with respect to Donor and that this intent was not carried out in the trust agreement as a result of a mistake of fact or law. As a result, the trust reformation was to be taken into account as of the initial date of the trust, so that the exception would permit the trust to be a grantor trust for income tax purposes from inception.

47. Letter Ruling 201803004 (Issued September 28, 2017; Released January 19, 2018)

IRS grants extension to trust for charitable contribution election

The trustees of a trust made charitable contributions during Year 2. The trust filed a return for Year 1 treating the charitable contributions made in Year 2 as paid in Year 1. An exception in Section 642(c) permits a charitable contribution paid after the close of the taxable year and on or before the last day of the year following the close of that taxable year to be treated as paid during such taxable year if an election is made. This is permitted if an election is filed under Section 642(c). However, due to inadvertence, the Section 642(c) election was not included with the Year 1 Form 1041 return for the trust. The income tax return filed for Year 2 did not take a deduction for the charitable contributions made in Year 2.

In this letter ruling, the Service applied the provisions of Treas. Reg. § 301.9100-3, which states that a request for relief will be granted when a taxpayer shows that the taxpayer acted reasonably and in good faith and that grant of relief will not prejudice the interests of the government. The IRS found that these requirements were met without much discussion, and the trust could take the Section 642(c) deduction in Year 1.

48. Green v. United States, 880 F.3d 519 (10th Cir. 2018)

Income tax charitable deduction for non-grantor trust limited to trust's adjusted basis in properties donated to charity

David M. Green and Barbara A. Green created an irrevocable dynasty trust in 1993. The beneficiaries of the dynasty trust were the children and descendants and charity. The trust stated that a distribution could be made from the trust to charity, but only to the extent that the deduction would not prevent the trust from qualifying as an electing small business trust or an S corporation. The trust owned a single member limited liability company called GDT which was disregarded for income tax purposes.

Hob-Lob Limited Partnership ("Hob-Lob") owns and operates most of the Hobby Lobby retail stores located nationwide. The trust was a 99% limited partner in Hob-Lob. In 2003, GDT purchased 109 acres of land in two industrial buildings in Lynchburg, Virginia for $10.3 million. GDT obtained the money to purchase the property through a distribution from Hob-Lob to the trust in 2003.

On March 19, 2004, GDT donated 73 of the 109 acres of land and the two industrial buildings to the National Christian Foundation Real Property, Inc. The National Christian Foundation is a recognized charity. The trust reported that its adjusted basis in Virginia property was $10,368,113 on the date of the donation.

In 2002, GDT purchased a church building and several out buildings in Ardmore, Oklahoma for $150,000. Subsequently in 2004, GDT donated the Ardmore property to the Church of the Nazarene. Its adjusted basis in the property is $160,477 and the property had a fair market value of $355,000.

In June 2003, GDT purchased 3.8 acres of land in Texas for $145,000. On October 5, 2004, GDT donated the Texas property to Lighthouse Baptist Church. The trust reported that its adjusted basis in the Texas property was $145,180 and the fair market value of the property was $150,000 on the date of the donation.

In October 2005, the trust filed its income tax return for 2004. The return claimed a charitable deduction totaling $20,526,383. This included the donations of real property as well as a $1,851,502.42 donation to Reach the Children Foundation, Inc. The return reported the trust's total adjusted basis in the three donated real properties as approximately $10.7 million, and that the properties' fair market value at the time of the donation was approximately $30.3 million. At no point in 2004 or any other tax year did the trust report as its income the properties' unrealized appreciation of approximately $19.6 million. On October 15, 2008, the trust filed an amended Form 1041 claiming a refund from the Internal Revenue Service for $3,194,748 in income tax and increasing the trust's reportable charitable deduction from $20,526,383 to $29,654,233.

The IRS denied the refund claim by the trust. It stated that the charitable deduction for the real property donated in 2004 was limited to the basis of the property contributed. The Western District of Oklahoma granted partial summary judgment in favor of the trust, concluding the trust was statutorily authorized to take a deduction equivalent to the fair market value of the properties as of the time of the donation.

On appeal, the Circuit Court first looked at the language of Section 642(c)(1). It stated that the Section applies only to estates and trusts. The deduction is limited to any amount of gross income which pursuant to the terms of the governing instrument paid for a charitable purpose. The Circuit Court then said that the central issue in this appeal is the amount of the deduction is under Section 642(c)(1).

The Circuit Court stated that there were four possible interpretations of the statutory language. One possible interpretation of the statutory phrase is that a charitable contribution must be made out of the gross income earned by the trust during the year in question.

A second possible interpretation is that a charitable contribution must be made exclusively out of gross income earned by the trust at some point in time, so long as that gross income is kept separate from the trust principal from the time it is earned until it is donated.

The third possible interpretation, and the one that both parties in the case appeared to urge, is that a charitable contribution need not be made directly from, but must instead simply be traceable to, current or accumulated gross income. If applied to contributions of real property, that would mean that the real property must have been purchased with, i.e. sourced from, the trust's current or accumulated gross income.

The fourth and final possible interpretation is that the amount of the charitable deduction is capped or limited by the amount of gross income earned by the taxpayer in the tax year in question.

Consequently, the statutory phrase "any amount of the gross income" was viewed by the Circuit Court as ambiguous.

The Circuit Court disagreed with the District Court's finding that the deduction should extend to the full amount of the fair market value of the donated property. Instead, it agreed with the IRS that the amount of the deduction should be limited to the adjusted basis in the property. The Circuit Court noted that because the trust never sold or exchanged the properties at issue and never realized the gains associated with their increases in market value, the trust was never subject to being taxed from those gains. Consequently, construing the Section 642(c)(1) charitable deduction to extend to unrealized gains would be inconsistent with the Internal Revenue Code's general treatment of gross income.

The Circuit Court found that until Congress acted to make clear that it intended for the Section 642(c)(1) deduction to extend to unrealized gains associated with real property originally purchased with gross income, that it cannot construe the deduction in that manner. It also noted that its interpretation found support in Mertens Law of Federal Income Taxation, which states that where appreciated property purchased from accumulated gross income is donated, the amount of the deduction is limited to the adjusted basis of the property rather than based on the fair market value of the donated property as well as, in part, in a decision dealing with the predecessor statute to Section 642(c)(1), W. K. Frank Trust of 1931 v. the Commissioner, 145 F.2d 411 (3d Cir. 1944). The Circuit Court also stated that if Congress had intended for the concept of "gross income" to extend to unrealized gains on property purchased with gross income, it would have said so.

The court finally rejected the argument of the trust that Section 512(b)(11) provided an alternative path for a deduction for charitable contributions by trusts that are sourced from unrelated business income. The trust argued that through the operation of Section 512(b)(11), its contribution of donated properties was deductible under Section 170. The Circuit Court rejected this theory, because the trust's claim for a refund made no mention of its Section 512(b)(11) legal theory, and this theory was never clearly raised and/or resolved by the District Court. The case was remanded to the District Court with directions to enter summary judgment in favor of the government.

49. **<u>Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue</u>, 371 N.C. 133 (2018); Petition for Writ of Certiorari granted on January 11, 2019 by U.S. Supreme Court**

N.C. Supreme Court holds that income taxation of out-of-state trust is unconstitutional

On June 8, the North Carolina Supreme Court affirmed the Court of Appeals' 2016 decision in <u>Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue</u>, _____ N.C. _____ (2018), upholding the Court of Appeals' (and Business Court's) finding that North Carolina General Statute Section 105-160.2 is unconstitutional as applied to the Kimberly Rice Kaestner 1992 Family Trust. The trust challenged the state of North Carolina's imposition of income tax on the basis that the trust's sole tie to the state is the residency of the trust's beneficiary, which connection is insufficient to allow taxation under the due process and commerce clauses of the U.S. Constitution.

The trust sought a refund of over $1.3 million in income taxes paid to the state of North Carolina for tax years 2005 – 2008. Upon denial of the claim, the trust brought suit challenging the constitutionality of the statute, both on its face and as applied to the taxpayer (the trust). Each of the Business Court, Court of Appeals, and North Carolina Supreme Court focused on the unique facts of the case in finding that the statute is unconstitutional as applied to the trust.

The trustee, during the period taxes were assessed, was a resident of Connecticut, the trust was governed by New York law, and North Carolina's only connection to the trust was the residence of the beneficiary. Further, all custodians of the trust's assets were located in Massachusetts, while all documents related to the trust, such as ownership documents and financial and legal records, were kept in New York. Finally, distributions from the trust were in the discretion of the trustee, and no distributions were made to the beneficiary in North Carolina during the relevant period.

The North Carolina Supreme Court emphasized that its opinion is limited to an "as applied" standard, meaning the court considered only whether the statute is constitutional as applied to the trust. In responding to the trust's continued challenge to the constitutionality of the statute, on its face, the North Carolina Supreme Court noted the presumption that "any act passed by the legislature is constitutional" and "any individual challenging the facial constitutionality of a legislative act must establish that ***no*** set of circumstances exists under which the [a]ct would be valid" (emphasis added). Because the trust presented only facts and evidence relevant to it, the North Carolina Supreme Court did not (and could not) consider whether the statute is unconstitutional on its face.

It has long been settled that a trust has a separate existence from its beneficiary, and therefore income to the trust is separately attributed. In determining whether the statute is constitutional, as applied to the trust, the North Carolina Supreme Court evaluated the requirements of the due process clause, specifically that the entity being taxed must "purposefully direct its activities" at the state, and the activities must be sufficiently abundant that the entity invokes the benefits and protections of that state's laws. Therefore, in order to withstand this challenge, the presence of the trust beneficiary in the state must satisfy the "purposeful" requirement to allow taxation of the

trust. The North Carolina Supreme Court concluded that the unilateral activity of the beneficiary did not satisfy this requirement.

Interestingly, Justice Sam Ervin, in dissent, noted the advancements of modern technology related to online and telephone communications, rather than in person. He opined a traditional analysis of physical presence in a state may need to be amended to reflect those changes in determining whether a taxpayer purposefully directs its activities to a state.

With the North Carolina Supreme Court's limited scope decision, as applied solely to the trust, taxpayers and advisers should carefully evaluate whether tax is due by a trust in North Carolina. For taxes already paid, and to the extent that a trust's *sole* connection with North Carolina is the residence of a trust beneficiary, the trustee should consider filing a claim for refund.

The United States Supreme Court granted the North Carolina Department of Revenue's petition for a writ of certiorari on January 11, 2019. It has been set for argument on Tuesday, April 15.

50. **Fielding v. Commissioner, 916 N.W.2d 323 (Minn. 2018)**

Attempt of Minnesota to tax irrevocable non-grantor trusts as resident trusts for state income tax purposes is unconstitutional under the due process clauses of United States and Minnesota Constitutions

Reid MacDonald, who was then domiciled in Minnesota, created four GST trusts on June 25, 2009. Each trust was initially funded with shares of nonvoting common stock in Faribault Foods, Inc. a Minnesota S Corporation. The original trustee for all four trusts was Edmund MacDonald, a California domiciliary. Reid MacDonald retained the power to substitute assets in the trusts. Consequently for the first thirty months of their existence, the trusts were "grantor type trusts". On December 31, 2011, Reid MacDonald relinquished his power to substitute assets in the trusts and the trusts ceased to be "grantor type trusts" and became irrevocable on December 31, 2011 (according to the court). Reid MacDonald was a resident of Minnesota at the time the trusts became irrevocable. As a result, each trust was then classified as a "resident trust" under Minn. Stat. § 290.01, subd. 7b(a)(2). Katherine Boone, a Colorado domiciliary, became the sole trustee for each trust on January 1, 2012.

Subsequently, the trusts filed Minnesota income tax returns as resident trusts, without protest, in 2012 and 2013. On July 24, 2014, William Fielding, a Texas domiciliary, became trustee of the trusts. Shortly thereafter, all of the shareholders, including the trusts, sold their shares in Faribault Foods, Inc. Because the trusts were defined to be Minnesota residents as a result of Reid MacDonald's Minnesota domicile in 2011, the trusts were subject to tax on the full amount of the gain from the 2014 sale of the stock as well as the full amount of income from other investments. The trusts filed their 2014 Minnesota income tax returns under protest, asserting that the Minnesota statute classifying them as resident trusts was unconstitutional as applied to them. The trusts then filed amended tax returns claiming refunds for the difference between the tax owed as resident trusts and the tax owed as non-resident trusts – a tax savings of more than $250,000 for each trust.

The Minnesota Commissioner of Revenue denied the refund claims and the Commissioner's decision was appealed to the Minnesota Tax Court on the grounds that the Minnesota statute

violated the due process and commerce clauses of the United States and Minnesota constitutions. The trusts and the Commissioner each moved for summary judgment. The Minnesota Tax Court ultimately concluded that defining the trust as a resident trust based upon Reid MacDonald's Minnesota residency at the time the trusts became irrevocable violated the due process provisions of the Minnesota and United States constitutions. The Minnesota Tax Court stated that the grantor's domicile at the time the trust becomes irrevocable was not "a connection of sufficient substance" to support taxing the trusts. Having decided the case on due process grounds, the Minnesota Tax Court did not reach the Commerce Clause.

The Minnesota Tax Court noted that a state's tax will satisfy the due process clause if there is some minimum connection between the state and the entity subject to the tax and a "rational relationship" between the income that the state seeks to tax and the protections and benefits conferred by the state citing Luther v. Commissioner of Revenue, 588 N.W. 2d 502 (Minn. 1999).

The Minnesota Supreme Court framed the issue as whether Minnesota may permissibly tax all sources of income to the irrevocable trusts simply because it had classified the trusts as residents based on events that predated the tax year at issue.

The Minnesota Tax Commissioner cited the following as factors requiring taxation:

1. Reid MacDonald was a Minnesota resident when the trusts were created;
2. Reid MacDonald was domiciled in Minnesota when the trusts became irrevocable and was still domiciled in Minnesota in 2014;
3. The trusts were created in Minnesota with the assistance of a Minnesota law firm which drafted the trust documents and until 2014 retained the trust documents;
4. The trusts held stock in a Minnesota S Corporation;
5. The trust documents provided that questions of law arising out of the trust documents were to be determined in accordance with Minnesota law; and
6. One beneficiary had been a Minnesota resident through the tax years in question.

The trusts, on the other hand, noted that:

1. No trustee had been a Minnesota resident;
2. The trusts had not been administered in Minnesota;
3. The records of the trust assets and income were maintained outside of Minnesota;
4. Some of the trusts' income was derived from investments with no direct connection to Minnesota; and
5. Three of the four beneficiaries of the trusts lived outside of Minnesota.

The Minnesota Supreme Court concluded that the contacts on which the Tax Commissioner relied were either irrelevant or too attenuated to establish that Minnesota's tax on the trusts income from all sources complied with due process requirements. It first noted the grantor's connections to Minnesota were irrelevant. The relevant connections were Minnesota's connection with the trustee and not the grantor who established the trusts years earlier.

It noted also that the stock was an intangible asset and cited cases holding that states cannot impose an income tax on trust property because possession or control of these assets was held by trusts that were not residents of or domiciled in a state. In addition, the Minnesota residency of one beneficiary did not establish the necessary minimum connection to justify taxing the trusts income. The grantor's decision to use a Minnesota law firm and the contacts with Minnesota predating 2014 were irrelevant.

As a result, the contacts between the trusts and Minnesota from 2014 on were tenuous. The trusts had no contact with Minnesota during the applicable tax year. All trust administration activities by the trustees occurred outside Minnesota.

The Court also noted that these trusts were inter vivos trusts that had not been probated in Minnesota courts and had no existing relationship to the Minnesota courts distinct from that of the trusts and the trust assets unlike other cases which involved testamentary trusts such as District of Columbia v. Chase Manhattan Bank, 689 A. 2d. 539 (DC 1997).

Attributing all income, regardless of source, to Minnesota for tax purposes would not bear a rational relationship with the limited benefits received by the trusts from Minnesota during 2014.

51. **South Dakota v. Wayfair, Inc., ___ U.S. ___ (2018)**

Supreme Court overrules Quill Corp. v. North Dakota

South Dakota, as many states, taxes the retail sales of goods and services in the state. Sellers are required to collect and remit the tax to the state, but if they do not, then in-state consumers are responsible for paying a use tax at the same rate. Under National Bellas Hess, Inc. v. Department of Revenue of Ill. 386 U.S. 753 (1967) and Quill Corp, Inc. v. North Dakota, 504 U.S. 289 (1992), South Dakota could not require a business that has no physical presence in South Dakota to collect its sales tax. Consumer compliance rates are notoriously low, however, and it is estimated that Bellas Hess and Quill caused South Dakota to lose between $48 and $58 million in tax revenue, annually. Out of a concern about the erosion of its sales tax base and the corresponding loss of funding for state and local services, the South Dakota legislature enacted a law requiring out of state sellers to collect and remit sales tax "as if the seller had a physical presence in the state." The act covers only sellers that, on an annual basis, deliver more than $100,000 of goods or services into South Dakota or engage in 200 or more separate transactions for delivery of goods or services into South Dakota.

Respondents were top online retailers with no employees or real estate in South Dakota, each meeting the minimum sales or transactions requirement. They did not collect the sales tax imposed by South Dakota. South Dakota filed suit in state court seeking a declaration that the requirements of the act were valid and applicable to the respondents and an injunction requiring respondents to register for licenses to collect and remit the sales tax. Respondents sought summary judgment, arguing that the act is unconstitutional. The trial court granted their motion. The South Dakota Supreme Court affirmed on the ground that Quill is controlling precedent.

In a five to four opinion, the Supreme Court held that the physical presence rule of Quill is unsound and incorrect and overruled Quill and National Bellas Hess. The Court noted that the physical presence rule has long been criticized as giving out of state sellers an advantage. It also noted that

each year, the physical presence rule becomes further removed from economic reality and results in significant revenue losses to the states. The Court felt that the physical presence rule is not a necessary requirement to satisfy due process concerns that there be some definite link or some minimum connection between a state and the person, property, or transaction it seeks to tax. In addition, Quill created resolved market distortions rather than resolving them. The Court observed that Quill was a judicially created tax shelter for businesses that limited their physical presence in a state, but sold their goods and services to consumers in a state, something that had become easier and more prevalent with the advancement of technology. Finally, Quill imposed the sort of arbitrary, formalistic distinction that the court's modern commerce clause precedents disavowed in favor of a case-by-case analysis of the purposes and effects.

52. **Notice 2018-61, 2018-31 IRB (July 13, 2018)**

IRS to issue regulations on effect of Section 67(g) on certain deductions for estates and nongrantor trusts

The U.S. Treasury Department and the IRS announced on Friday, July 13, 2018, that they intend to issue regulations on the impact of new Section 67(g) of the Internal Revenue Code of 1986 on certain deductions for estates and nongrantor trusts. Section 67(g) was added to the Code by the 2017 Tax Act (P.L. 115-97) and suspends temporarily miscellaneous itemized deductions.

Tax practitioners expressed concern that Section 67(g) might inadvertently eliminate the deduction for costs of estate and trust administration. Practitioners have also requested guidance on whether the suspension of miscellaneous itemized deductions prohibits trust and estate beneficiaries from deducting on their individual returns the excess deductions of the trust or estate incurred during the trust's or estate's final taxable year.

Treasury and the IRS have stated that forthcoming regulations will clarify that the costs of trust or estate administration are not miscellaneous itemized deductions suspended by Section 67(g). Treasury and the IRS have also stated that new regulations will address the impact of Section 67(g) on the ability of beneficiaries to deduct an estate's or trusts excess deductions upon termination of the estate or trust.

Under Section 67(e) of the Code, the adjusted gross income of an estate or nongrantor trust is computed in the same manner as that of an individual, with two exceptions. Section 67(e)(1) permits an estate or nongrantor trust to deduct in computing adjusted gross income the costs incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in the estate or trust. Such expenses generally include, for example, fiduciary compensation and court accounting costs. Section 67(e)(2) provides an exception for deductions allowable under Section 642(b) (relating to the personal exemption of an estate or nongrantor trust), Section 651 (relating to distributions of income to beneficiaries of simple trusts), and Section 661 (relating to distributions of income and principal to beneficiaries of complex trusts).

New Section 67(g) of the Code suspends the deduction for miscellaneous itemized deductions for any taxable year beginning after December 31, 2017, and before January 1, 2026. Some

practitioners expressed concern that Section 67(g) may inadvertently eliminate the ability of an estate or nongrantor trust to deduct the administration expenses described in Section 67(e)(1).

On the termination of a nongrantor trust or estate, Section 642(h) of the Code allows the beneficiaries succeeding to the property of the nongrantor trust or estate to deduct the trust's or estate's unused net operating loss carryovers under Section 172 of the Code and unused capital loss carryovers under Section 1212 of the Code. If an estate or nongrantor trust has deductions (other than deductions for personal exemptions or charitable contributions) in excess of gross income in its final taxable year, then Section 642(h) allows the beneficiaries succeeding to the property of the estate or trust to deduct such excess on their individual returns. Capital loss carryovers and net operating loss carryovers are taken into account in calculating adjusted gross income and are not miscellaneous itemized deductions. Section 67(g) therefore does not affect the ability of a beneficiary to make use of a capital loss carryover or net operating loss carryover received from an estate or nongrantor trust.

The excess deductions of an estate or nongrantor trust, however, are allowable only in computing taxable income and are not covered by an exception from miscellaneous itemized deductions in Section 67(b). Absent guidance to the contrary, the excess deductions of an estate or nongrantor trust are now disallowed by Section 67(g) for taxable years beginning after December 31, 2017, and before January 1, 2026. The inability of beneficiaries to claim excess deductions may create unwelcome and unanticipated consequences. For example, it could artificially affect timing of distributions, delay closing of estates, and create incongruity in the treatment of administration expenses — permitting them as deductions to an estate or trust but denying them when passed-out to beneficiaries.

Notice 2018-61 announces that Treasury and the IRS intend to issue regulations "clarifying that estates and nongrantor trusts may continue to deduct expenses described in Section 67(e)(1)" for taxable years during which Section 67(g) suspends miscellaneous itemized deductions. Estates and nongrantor trusts may rely on Notice 2018-61 in continuing to deduct expenses under Section 67(e)(1).

Notice 2018-61 includes a reminder that Section 67(g) does not affect the determination of administration costs defined in Section 67(e)(1) of the Code. Pre-existing law continues to apply to the identification of administration expenses under Section 67(e)(1), including the treatment of "bundled" trustee's fees.

Notice 2018-61 also notes that Treasury and the IRS are studying whether Section 67(e) deductions and other deductions that would not be considered miscellaneous itemized deductions to an estate or nongrantor trust should continue to be regarded as miscellaneous itemized deductions when included by a beneficiary as an excess deduction under Section 642(h)(2). Treasury and the IRS intend to issue regulations addressing whether a beneficiary may claim the excess deductions of a terminating estate or trust notwithstanding the suspension of miscellaneous itemized deductions under Section 67(g). In connection with the drafting of new regulations, Treasury and the IRS are seeking public comments on whether amounts deductible under Section 642(h)(2) of the Code should be analyzed separately from other miscellaneous itemized deductions when applying

Section 67 of the Code. Notice 2018-61 does not provide a timeframe for when Treasury and the IRS may issue new regulations.

ASSET PROTECTION

53. Indiana Senate Bill 265 (May 5, 2019)

Indiana Enacts Self-Settled Asset Protection Trust Legislation

On April 9, 2019, the Indiana legislature enacted S.B. 265, the purpose of which was to amend the Indiana Code concerning trusts and fiduciaries. The Indiana governor signed the act on May 5, 2019. One important provision of the act was the addition of a new Section 30-4-8 to the Indiana Code to permit the establishment of "Legacy Trusts" which are a form of self-settled domestic asset protection trusts ("DAPTs") and provide spendthrift creditor protection to the settlors of Legacy Trusts. As of the effective date of July 1, 2019, Indiana will become the eighteenth state to have DAPT-enabling legislation. The other seventeen states are Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming.

The Indiana Legacy Trust law is similar to the statutes of the other states that permit DAPTs. Either the owner of property or the holder of general power of appointment can transfer assets to a Legacy Trust. The transfer of assets to the Legacy Trust must be a "qualified disposition." To be a qualified disposition, the Legacy Trust must be irrevocable, have a "qualified trustee" as one of the trustees, incorporate Indiana law to govern the validity, construction, and administration of the Legacy Trust, and have a spendthrift clause.

The transferor of assets to a Legacy Trust must sign a "qualified affidavit" which affirms that:

1. The transferor has full right to transfer property to the trust;
2. The transfer will not cause the transferor to be insolvent;
3. The transferor does not intend to defraud creditors with the transfer;
4. There are no pending or threatened court actions against the transferor other than those identified by the transferor in the affidavit;
5. The transferor is involved in no administrative proceedings other than those identified in the affidavit;
6. The transferor does not contemplate filing for bankruptcy; and
7. The property being transferred to the trust is not derived from unlawful activities.

A married transferor must provide a copy of the qualified affidavit to his or her spouse.

The Legacy Trust must have a "qualified trustee," which is either an individual residing in Indiana or an entity authorized by Indiana law to act as a trustee. Qualified trustees must:

1. Maintain or arrange for the custody of the property in the trust;
2. Maintain records of the trust on an exclusive or nonexclusive basis;
3. Prepare or arrange for the preparation of all tax returns; and
4. Materially participate in the administration of the trust.

The act addresses the consequences if a non-Indiana court seeks to assert jurisdiction over a Legacy Trust or apply the law of a state other than Indiana. The act provides that if a court declines to apply Indiana law in determining the effect of a spendthrift provision in a Legacy Trust, the trustee must immediately resign and thereafter can only transfer the trust property to another trustee. The act also provides that an Indiana court "to the maximum extent permitted by the United States Constitution and the Indiana Constitution," must exercise jurisdiction over the trust even if a court of another jurisdiction has or may have proper jurisdiction of a matter involving the trust.

The only claims of creditors that can be enforced against the assets in a Legacy Trust are:

1. Fraudulent transfer claims under the Indiana Uniform Fraudulent Transfer Act;
2. Child support obligations; and
3. Marital obligations incurred in a divorce (when the transfer of assets to the trust occurs after the marriage or within thirty days of the marriage).

Claims are subject to a two year statute of limitations period.

Transferors can have certain rights and powers with respect to the Legacy Trust. A transferor to a Legacy Trust may serve as investment advisor to the trust. The following provisions can be included in a Legacy Trust for a transferor:

1. The transferor can have the power to veto a distribution from the trust;
2. The transferor can have a testamentary limited power of appointment;
3. The transferor can have a power to take out principal under an ascertainable standard: and
4. The transferor can have the right to remove a trustee or trust director and appoint a new trustee or trust director who is not a related or subordinate party under Section 672(c) of the Internal Revenue Code.

With Indiana becoming the eighteenth DAPT state, other states are likely to at least consider DAPT legislation, if not join the states that have DAPT legislation. Connecticut is currently considering DAPT legislation.

54. <u>Toni 1 Trust v. Wacker</u>, 413 P.2d 1199 (AK 2018)

Alaska Supreme Court determines that Alaska state courts do not have exclusive jurisdiction over fraudulent transfer actions under AS 34.40.110(k)

Donald Tangwall sued William and Barbara Wacker in Montana state court in 2007. The Wackers counterclaimed against Tangwall, his wife, Barbara Tangwall, his mother-in-law, Margaret "Toni" Bertran, and several trusts and businesses owned or run by the Tangwall family. As a result, several default judgments were entered against Donald Tangwall and his family.

In 2010, before the issuance of the last of the default judgments, Toni Bertran and Barbara Tangwall transferred parcels of real property to an Alaskan trust called the "Toni 1 Trust" which was an Alaska self-settled domestic asset protection trust." The Wackers filed a fraudulent transfer

action under Montana law in Montanan state court alleging that the transfers were fraudulent and default judgments were entered against Barbara Tangwall, the Toni 1 Trust, and Toni Bertran.

After the issuance of the fraudulent transfer judgments by the Montana court, the Wackers purchased Barbara Tangwall's one half interest in one of the parcels at a sheriff's sale in partial satisfaction of their judgment against Donald Tangwall and the family. Before the Wackers could purchase the remaining half interest, Toni Bertran filed for Chapter 7 bankruptcy in Alaska. As a result, her interest in the property in the Toni 1 Trust was subject to the jurisdiction of the federal bankruptcy court.

In December 2012, Donald Tangwall, as trustee of the Toni 1 Trust, filed a complaint in the bankruptcy court alleging that the service on the trust in the Montana fraudulent transfer action was defective, which rendered the judgment against the trust void. However, rather than litigate the issue of service in Montana, the bankruptcy trustee brought a fraudulent transfer claim against Tangwall under the federal bankruptcy fraudulent transfer statute. The bankruptcy court entered a default judgment against Tangwall, which judgment was sustained upon appeal.

Tangwall then sought relief in Alaska state court in which he argued that AS 34.40.110 granted Alaska courts exclusive jurisdiction over any fraudulent transfer actions against the trust. On this basis, Tangwall sought a declaratory judgment stating that all judgments against the trust from other jurisdictions were void and that no future actions could be maintained against the trust because the statute of limitations had run.

The Alaska Superior Court dismissed this complaint and Tangwall appealed. The Alaska Supreme Court found that AS 34.40.110(k) could not limit the scope of the jurisdiction of other states. Citing Tennessee Coal, Iron and Railroad Company v. George, 233 U.S. 354 (1914), the Court held that states are not constitutionally compelled to acquiesce to sister states' attempts to circumscribe their jurisdictions over actions. It stated that Tennessee Coal held that the Full Faith and Credit Clause of the United States Constitution does not compel states to follow another state's statutes claiming exclusive jurisdiction over suits based on a cause of action "even though the other state created the right of action." The Court did acknowledge that the Alaska legislature attempted to grant Alaska courts exclusive jurisdiction over claims against an Alaska self-settled domestic asset protection trust. It also acknowledged that several other states had similar statutes and that similar statutes do restrict their jurisdiction. However, the court found that under Tennessee Co, the assertion of exclusive jurisdiction did not render a fraudulent transfer judgment against an Alaskan trust from a Montana court void for lack of subject matter jurisdiction.

In addition, the court found that it could not grant Tangwall relief under federal judgment. It noted that Tennessee Coal only addressed the state's ability to restrict the jurisdiction of sister states. However, Marshall v. Marshall, 547 U.S. 293 (2006), concluded that state efforts to limit federal jurisdiction were invalid even though the state created the right of action that gave rise to the suit. It noted that AK 34.40-110(k) purported to grant Alaska courts exclusive jurisdiction over all fraudulent transfer claims against Alaska self-settled domestic asset protection trusts. Because 28 U.S.C. § 1334(a) gives federal courts' jurisdiction over some of these claims, the Alaska law conflicted with federal law to the extent that it was impossible to comply simultaneously with both. Consequently, under the Supremacy Clause of the Constitution, state courts are precluded from

limiting federal jurisdiction. Therefore, relief could not be granted to Tangwall from the federal judgment.

55. **Olson v. Marshack, ___ F. Supp. 3d ___ (C.D. Cal. 2018)**

U.S. District Court declines to approve settlement of bankruptcy trustee with respect to offshore trust

In 2010, Jana W. Olson was sued in California Superior Court by Passport Management LLC. Within a month of the service of the lawsuit, Olson transferred her beneficial interest in a self-settled Cook Islands offshore asset protection trust from herself to her two minor children for no consideration. This transfer had the appearance of a fraudulent transfer. Subsequently, Olson filed a petition for bankruptcy. Passport Management LLC became the primary creditor of the bankruptcy estate.

At some point, Olson agreed to repatriate the money in the self-settled Cook Islands trust and a stipulated order was entered by the bankruptcy court directing Olson to do so. The bankruptcy court's order specifically required repatriation but did not decide if the money was the property of the bankruptcy estate.

Olson then, according to the district court, proceeded to disobey the bankruptcy court's order by sabotaging the repatriation effort with a letter designed to convince the Cook Islands trustee that her request to repatriate the money was made under duress. As a result, apparently, the Cook Islands trustee refused to repatriate the money. The bankruptcy court then jailed Olson for more than a year for civil contempt. Eventually, the bankruptcy trustee decided that jail was not going to convince Olson to repatriate the funds in the trust from the Cook Islands. The bankruptcy trustee then negotiated an agreement with Olson and Olson's father and Olson's brother, as trustee of a new California trust with the two minor children as beneficiaries, under which the money would be returned to California with approximately 80 percent going to the bankruptcy estate and 20 percent to the California trust.

After the repatriation of the funds to California, the bankruptcy trustee moved for approval of the compromise agreement before the bankruptcy court. Passport Management opposed the motion claiming that there was no authority to disburse property of the bankruptcy estate in contravention of the priority rules and that, in any event, there was no reason to allow Olson effectively to be rewarded for her contempt. Passport Management LLC also argued that other pressure could have been brought to bear before a compromise was struck that allowed Olson or her family to retain part of the funds.

The bankruptcy trustee argued that the agreement was the only way to get property back into the reach of the United States court and that 80 percent was better than getting nothing at all. The trustee also believed that the fraudulent transfer claim could have been easily won, but that subsequent collection would have been virtually impossible because of the difficulty of seeking collection in the Cook Islands. As a result, the bankruptcy court granted the motion to approve the compromise, but declined to determine whether the trust funds held in the Cook Islands were always the property of the bankruptcy estate.

The district court rejected the compromise. First, the court said that without a judgment avoiding the transfers, the Cook Islands funds were not a part of the bankruptcy estate at the time of the petition. The transfers would have to be formally avoided through a fraudulent transfer claim to make the funds part of the bankruptcy estate. In addition, the bankruptcy court had no equitable duty to approve the compromise after Olson and her family arranged for the repatriation money in reliance on the settlement. This effectively minimized the independent role of the bankruptcy court in the process. The court also agreed with Passport Management that a benefit to Olson's minor children was an indirect benefit to Olson herself as the money set aside in trust was money that Olson did not have to pay for her children's welfare. The court then rejected the argument of the bankruptcy trustee that the minor children might be individually liable for their mother's debt as beneficiaries of the trust. The court noted that the normal rule is that beneficiaries are not liable for the wrongful acts of the trust. As a result, the district court rejected the settlement agreement.

FIDUCIARY CASES

56. **Ajemian v. Yahoo!, Inc., 84 N.E. 3d 766 (Mass. 2017), petition for cert. docketed sub nom. Oath Holdings, Inc. v. Ajemain (U.S. Jan. 19, 2018 (No. 17-1005)**

The Stored Communications Act (the "SCA") does not prevent Yahoo!, Inc. ("Yahoo") from voluntarily disclosing emails from a decedent's account to the decedent's personal representatives at the request of the personal representatives; it remains to be settled whether the SCA compels Yahoo to do the same

John Ajemian died intestate, and his siblings, Robert Ajemian and Marianne Ajemian, were appointed as his personal representatives. Robert and Marianne asked Yahoo to provide access to the contents of John's e-mail account. Yahoo refused to release the contents of the account, although they did provide "subscriber information" upon Robert and Marianne obtaining a court order mandating disclosure to the account holder's personal representatives.

Robert and Marianne filed a complaint in the Probate and Family Court seeking a judgment that they were entitled to unfettered access to the messages in the account. Yahoo filed a cross motion for summary judgment arguing that the SCA prohibited the requested disclosure, and, even if it did not, Yahoo was permitted to deny access to, or even delete the contents of, the account at its sole discretion based on the service contract entered into at the time the e-mail account was created.

The judge granted Yahoo's motion for summary judgment solely on the basis that the SCA barred Yahoo from complying with the requested disclosure. Robert and Marianne appealed to the Massachusetts Appeals Court, and the Supreme Judicial Court of Massachusetts transferred the case to themselves as a matter of first impression.

The SCA prohibits entities that provide "service[s] to the public" from voluntarily disclosing the "contents" of stored communications unless certain statutory exceptions apply. The "agency exception" allows a service provider to disclose the contents of stored communications "to an addressee or intended recipient of such communications or an agent of such addressee or intended

recipient." The "lawful consent exception" allows disclosure "with the lawful consent of the originator or an addressee or intended recipient of such communication."

The Supreme Judicial Court of Massachusetts ruled that the SCA does not prohibit Yahoo from voluntarily disclosing the contents of an e-mail account to the personal representatives of the account holder's estate, because the lawful consent exception applies.

The Court found that the agent exception does not apply because personal representatives are not agents of the decedent, as they cannot be controlled by the decedent. However, the lawful consent exception does apply such that the personal representatives of a decedent can give lawful consent to release of the content of the account. The Court reasoned that to find otherwise would result in a class of digital assets—stored communications—that could not be marshalled by personal representatives. The Court found that this was not the intent of the SCA. Therefore, based on the Court's statutory interpretation analysis, personal representatives are capable of giving "lawful consent" to the disclosure on behalf of the account holder, and "actual consent" by the decedent is not required to qualify for the "lawful consent exception" under the SCA.

Because the lawful consent exception applies, Yahoo is not prevented by the SCA from releasing the contents of the account to the personal representatives. The Supreme Judicial Court of Massachusetts remanded the issue of whether Yahoo was compelled to release the contents of the account to the Probate and Family Court, but strongly signaled that if the lower court were to find that Yahoo was not compelled to release the contents, the Supreme Judicial Court of Massachusetts would overturn that ruling and compel Yahoo to release the contents of the account.

57. **Laborers' Pension Fund v. Miscevic, No. 17-2022 (7th Cir. Jan. 29, 2018)**

ERISA does not preempt the Illinois slayer statue, and the Illinois slayer statute applies where the deceased was killed by an individual found not guilty by reason of insanity

Evidence produced at her criminal trial showed that Anka Miscevic killed her husband, Zeljko Miscevic, in January 2014; however, she was found not guilty by reason of insanity. Despite the finding that she was responsible for her husband's death, Anka then claimed she was entitled to her deceased husband's pension plan, which was governed by federal ERISA law. A claim was also made on behalf of their minor son for the benefits. Their minor son was awarded the benefits from the pension plan. Anka appealed.

Illinois has a "slayer statute," which provides that "a person who intentionally and unjustifiably causes the death of another shall not receive any property, benefit, or other interest by reason of the death." However, neither federal ERISA law nor the pension's governing documents contains an express slayer provision; therefore, if federal law governs, the named beneficiary would receive the assets, despite the operation of a slayer statute under state law.

On appeal, the Court of Appeals for the Seventh Circuit upheld the interpretation that a slayer is precluded from obtaining the benefits payable under the decedent's pension plan even if they were

found not guilty by reason of insanity. The Court reasoned that slayer statutes are traditionally an area of state regulation, and it rejected Anka's argument that Congress intended to preempt the slayer statutes through ERISA. ERISA was enacted after it was well established that an individual who kills another individual cannot benefit as a result of that death. Therefore, Congress could have clearly stated that it intended to change that result in certain situations, but their failure to explicitly state that intent results in a determination that it was not their intent.

Further, the Court held that Illinois' statute that provides that "a person who intentionally and unjustifiably causes the death of another" is broad enough to encompass a situation where an individual is found not guilty by reason of insanity. They deferred to state law decisions to interpret the statute. Anka argued that the killing was justifiable because she was found not guilty. The Court rejected this argument on the grounds that an insanity defense is an "excuse" defense, not a "justification" defense. The decision rests on lower court decisions interpreting the statute, and therefore the Court does acknowledge that the interpretation may be different in other states.

58. **Lynch v. Barba, 2018 WL 1613834, C.A. No. 12083-MG (Del. Ch. Ct. 2018)**

Trustee is entitled to summary judgment when beneficiary cannot substantiate his breach of fiduciary duty allegations and has waited too long to file his lawsuit against the trustee

Ethel M. Lynch died in August of 2010. She named her daughter, Rhonda Barba as executor of her estate and trustee of two testamentary trusts. Rhonda predeceased Mrs. Lynch, so Rhonda's husband, Francis Barba, qualified as the named successor executor and trustee.

Mrs. Lynch had transferred her property to a Revocable Trust which was to be distributed at her death, one-half to a Special Needs Trust for her husband, Mr. Lynch, and the remainder was to remain in the Revocable Trust for the benefit of Rhonda. Upon Rhonda's death, the Revocable Trust provided the principal of the Special Needs Trust would be distributed in accordance with Rhonda's testamentary power of appointment or to her surviving issue per stirpes. The beneficiaries after Mrs. Lynch's death are Mr. Lynch and Rhonda's two sons, Matthew and Eric Barba.

Mr. Barba and Mr. Lynch did not have a good relationship prior to Mr. Barba serving as Trustee for Mr. Lynch's Trust, and this additional relationship only exacerbated their disagreements. Mr. Lynch filed a 78 count Complaint alleging Mr. Barba did not act in good faith while serving as executor for Mrs. Lynch's estate and as trustee of the Special Needs Trust.

Among his many complaints, Mr. Lynch claimed Mr. Barba breached the fiduciary duties he owed Mr. Lynch as trustee of the Special Needs Trust by selling trust/estate property for less than its fair market value, refusing to change the name of the trust to remove "special needs," improperly moving and converting trust assets for personal use, failing to communicate with the beneficiary, failing to make distributions when requested, wasting trust assets and failing to provide accountings or other required reports as requested.

Mr. Barba filed a Motion for Summary Judgment requesting the trial court dismiss Mr. Lynch's Complaint, as there were no disputed facts to support the allegations that Mr. Barba had failed to meet his fiduciary obligations. Mr. Barba also asserted Mr. Lynch's claims were time barred and that the doctrine of laches prevented Mr. Lynch from asserting them. Both Mr. Barba and Mr. Lynch requested that the Special Needs Trust be terminated and all remaining assets be distributed to Mr. Lynch.

A plaintiff has the burden of proving his allegations. A plaintiff who fails to present specific evidence of a breach of duties owed by a trustee will not be successful.

Patricia Griffin, a Master in the Court of Chancery of Delaware, submitted a report to the Chancery Court containing her recommendations for action on the pending Motion for Summary Judgment. Overall, the Master found that Mr. Barba did not violate his fiduciary duties as trustee.

The Will granted the executor and trustee of the Special Needs Trust broad fiduciary powers along with the ability to hold or dispose of property in the trustee's discretion. When assessing the appropriateness of Mr. Barba's actions as trustee, Delaware applies a prudent investor standard. When the trustee acts with skill, care, diligence and prudence in light of the circumstances, they will not be found to violate their fiduciary duty to the beneficiary as a result of their actions.

In reviewing Mr. Barba's actions, the Master found that Mr. Lynch presented insufficient evidence to support any of his claims for breach of fiduciary duty. Mr. Barba sold the real property held in the estate for their appraised values and Mr. Lynch did not provide any factual support that the properties were sold for less than their fair market value. The Master also found that the Special Needs Trust expressly authorized employing and compensating advisors for the proper administration of the trust. Mr. Barba also demonstrated his compliance with the Trustee's duty to keep accurate records contrary to the assertion of Mr. Lynch.

With respect to the exercise of Mr. Barba's discretion, the Master held that to determine if Mr. Barba breached his duties to Mr. Lynch, she had to determine whether the funds distributed to the beneficiary were consistent with the authority provided by the Special Needs Trust and Delaware law, not whether Mr. Lynch received all of the payments he requested. Because Mr. Barba was granted the sole and uncontrolled discretion to make payments from the trust to Mr. Lynch, the Master found that his failure to agree to every request from Mr. Lynch did not itself constitute a breach of the trustee's duty.

The Master further found that even if Mr. Lynch had one or more valid claims, laches would bar his claims. To support the affirmative defense of laches, the defendant must prove the claimant had knowledge of the claim, the claimant unreasonably delayed in bringing the claim and that delay resulted in prejudice to the defendant.

The Master found that Mr. Lynch knew in September 2011 about the transfers of property and actions he complained of during the administration of Mrs. Lynch's Estate. The inventory for Mrs. Lynch's Estate was filed in March 2011 and the final accounting was filed in September 2011, a copy of which was sent to Mr. Lynch. Mrs. Lynch's estate closed in December, 2011.

Mr. Lynch did not assert his claims until March 2016, over four and a half years after the claim arose. By that time the Estate was closed and all property had been distributed. Therefore, if Mr. Lynch were allowed to proceed, the Estate would have to be reopened and beneficiaries would have to find a way to reimburse the Estate to satisfy Mr. Lynch's claims. On these facts, the Master found that all three requirements for laches were satisfied, barring Mr. Lynch's claims.

Lastly, the Master addressed Mr. Lynch's and Mr. Barba's request to terminate the Special Needs Trust and to allow distribution of the assets to Mr. Lynch. Delaware law allows a court to terminate a trust if all beneficiaries consent and the court determines the settlor's objectives or purpose for the trust has become impossible to achieve, administration is difficult or impractical, and/or continuing the trust is not in the best interest of the beneficiaries.

The Master found that termination of the Special Needs Trust was appropriate because of the broad trust purposes to benefit Mr. Lynch and because of the unlikelihood of locating a successor trustee willing to serve. Mr. Barba was not willing to continue to serve as trustee and the successor trustee named in the trust instrument also had declined to serve.

59. <u>Bullard v. Hoffman</u> (In re Mayette E. Hoffman Living Trust U/A dated August 4, 1997), 812 S.E.2d 401 (N.C. Ct. App. 2018)

A trustee's egregious conduct is not a prerequisite to awarding attorney's fees under the UTC in a judicial proceeding involving the administration of a trust

Kimberli Bullard and James Hoffman were co-trustees of a trust for the benefit of their father. The primary asset of the trust was the father's residence. When their father was moved to a nursing home, the father's attorneys notified Kimberli and James of their responsibility as fiduciaries to co-manage the property, including dealing with repair and maintenance of the residence. Kimberli and James could not agree on management of the property and the residence was left vacant, bills were unpaid, insurance lapsed and the property generally deteriorated.

After approximately two years, Kimberli sent James a letter alleging James' various breaches of fiduciary duty and requesting that he voluntarily resign as co-trustee. James acknowledged receipt of the letter but took no other action. Kimberli then petitioned the Guilford County Superior Court to remove James as co-trustee. While the removal case was pending, there was a tenant interested in leasing the property but James refused to sign the lease. Upon petition by Kimberli, the Clerk of the Superior Court entered an order approving the lease.

After the Clerk removed James as co-trustee, Kimberli filed a petition for attorney's fees in the amount of $26,096.70. The Clerk awarded $7,243 in attorney's fees as reflective of the fees incurred during the time that the petition to remove James as co-trustee was pending. The Clerk found that James' actions during that period were "egregious and obstructionist" in a manner that warranted an award of attorney's fees. However, the attorney's fees incurred outside of that period were denied as being irrelevant to James' "egregious and obstruction behavior." James' appeal of this fees award to the Guilford County Superior Court was denied. James appealed this decision to the North Carolina Court of Appeals.

Under the North Carolina Uniform Trust Code a court may award costs and expenses, including reasonable attorney's fees, as provided in the General Statutes. In turn, the General Statutes permit the court to apportion costs amongst the parties in the court's discretion. At common law, litigation expenses were generally only chargeable against the other party in the case of egregious conduct, such as bad faith or fraud.

The North Carolina Court of Appeals denied James' appeal and upheld the award of attorney's fees. The Court of Appeals reasoned that the common law principle requiring egregious conduct for an award of attorney's fees is not required by the applicable statutes, which leave the award to the court's discretion. The Court of Appeals further held that even if egregious conduct were a prerequisite to an award of attorney's fees, James' conduct while the removal action was pending was, in fact, egregious. James was aware that the trust property was continuing to lose value while vacant, but he refused to take corrective action. Therefore, the Clerk did not abuse her discretion in her award of attorneys' fees to Kimberli.

60. **<u>In Estate of Forgey</u>, 298 Neb. 865 (2018)**

Nebraska Supreme Court awards damages and legal fees for trustee's failure to inform and report

This dispute involved, among other related matters, the proper measure of damages for failing to provide an accounting for the Glenn G. Forgey Revocable Trust ("Trust"). The grantor of the trust, Glenn G. Forgery ("Grantor") died in 1993.

Under the terms of the Trust, following the Grantor's death and payment of the Grantor's debts, funeral expenses, estate expenses, and federal estate taxes, the remaining assets of the Trust were to be divided into separate trusts for the benefit of each of the Grantor's surviving children and the descendants of the Grantor's children who did not survive him. The Grantor had three surviving children: Lyle A. Forgey ("Lyle"), Bessie I. Forgery-McCoy ("Bessie"), and Wayne Forgey ("Wayne"). Wayne died before the lawsuit commenced.

The trust instrument named Lyle sole trustee and gave him broad discretion to manage the Trust. The Trust instrument also required Lyle to provide an annual accounting to the beneficiaries.

Lyle failed to file timely the Grantor's federal estate tax return, resulting in the assessment of interest and penalties. Because the Trust owned mostly illiquid assets and none of the family members wanted to sell Trust assets, Lyle made an election under the Internal Revenue Code to pay estate taxes on an installment basis. The installment payment of estate taxes contributed to a significant delay in terminating the Trust.

The Trust's primary assets consisted of agricultural land, stock in a small local bank, and cash. The Trust instrument required allocation of all the bank stock to Lyle's share. Before the Grantor's death, the Grantor, Lyle, and Wayne conducted jointly a cattle ranching business on the land and divided the profits 20 percent to the Grantor, 45 percent to Lyle, and 35 percent to Wayne. Although the Grantor owned the land, Lyle and Wayne did not pay rent to the Grantor. Lyle and

Wayne continued operating the ranching business in the same manner after the Grantor's death, but paid the Grantor's 20 percent profit share to the Trust.

In 2013, Wayne's surviving spouse Marvel Forgey ("Marvel") and her children brought suit against Lyle because after 20 years the Trust still had not been divided into separate shares. These plaintiffs also alleged various breaches of fiduciary duty and sought to remove Lyle as trustee. Among other claims, Marvel and Bessie contended that Lyle breached his fiduciary duties by failing to charge rent to himself and Wayne for use of the land in the ranching business. They also contended that Lyle breached his fiduciary duties by failing to timely file the federal estate tax return and by failing to render accounts as required by the Trust instrument.

The trial court ultimately dismissed most of the breach of fiduciary duty claims, but ordered the termination and division of the Trust. The court determined what the values of the Trust assets were at the time of the Grantor's death. The court assigned assets to each of the shares based on their values in 1993. Under this method, Lyle's share received all the bank stock and Wayne's and Bessie's shares each received one-half the land. The court used cash and other assets to equalize the value of the shares. The court then allocated income and expenses to each share over the 20-year period based on the asset to which the income and expenses related. For instance, Lyle's share received the benefit of all the bank stock dividends.

Marvel appealed the trial court's order, contending, among other things, that the trial court should have awarded Marvel and Bessie attorneys' fees and that the trial court erred in failing to assess damages against Lyle for failing to render an accounting.

Nebraska law before 2005 required a trustee to keep the beneficiaries reasonably informed of the trust and its administration. After the enactment of the Uniform Trust Code in 2005, Nebraska law required a trustee to send the beneficiaries, at least annually, a report of the trust property, liabilities, receipts, and disbursements. The Trust instrument also required the trustee to account to the beneficiaries. Normally, an accounting is the appropriate remedy for failing to inform and report to the beneficiaries.

Typically, a trustee who successfully defends against claims for breach of fiduciary duty may reimburse himself for the attorneys' fees from the trust. When the trustee creates the circumstances that permit the beneficiaries to question the trustee's actions, the trustee should bear his own attorneys' fees.

The Nebraska Supreme Court held that because Lyle's failure to keep the beneficiaries informed caused the misunderstandings and complications that led to the litigation, an accounting was not a complete remedy. In the Court's opinion, Bessie failed to raise with Lyle the issue of rent for the agricultural land because she had no information about the ranching business or the value of the land. The Court therefore ordered that Lyle transfer to Bessie's share an amount equal to one-half the rent he should have collected from himself and Wayne.

The Court also ordered Lyle to transfer an amount equal to the assessed penalties and interest resulting from the failure to timely file the estate tax return equally to Bessie's and Wayne's shares. Finally, the Court found that the trial court should have awarded the plaintiffs their attorneys' fees.

Without an award of attorneys' fees, there would be no consequence for Lyle failure to inform and report. Furthermore, Bessie and Marvel had expended considerable funds enforcing their statutory right to an accounting. In the Court's opinion, failing to reimburse Bessie and Marvel would produce an inequitable result.

61. <u>Morgan v. Superior Court of Orange County</u>, 23 Cal. Rptr. 3d 647 (Cal. App. 2018)

California court holds that predecessor trustee cannot assert the attorney-client privilege against a successor trustee and that any provision of a trust instrument seeking to do so violates public policy

This case arose during litigation between Thomas Edward Morgan, III ("Morgan"), the trustee and a beneficiary of the Amended and Completed Restated Beverly C. Morgan Family Trust dated November 6, 2013 ("Trust"), and Nancy Morgan Shurtleff, John Evans Morgan, and Nancy Morgan Shurtleff's daughters Kathleen Shurtleff and Jessica Shurtleff (collectively, the "Shurtleffs"), who are beneficiaries of the Trust. Morgan became sole trustee of the Trust following the death of the settlor, Beverly C. Morgan, in January 2014. Shortly after Morgan became trustee, the Shurtleffs filed a petition in the Probate Court for Orange County, California ("Probate Court"), seeking reformation of the Trust and removal of Morgan as trustee. The litigation continued for three years.

In April 2017, the Probate Court removed Morgan as trustee of the Trust and named Bruce and Lee Ann Hitchman (the "Hitchmans") as successor co-trustees. The Probate Court ordered Morgan to turn over to the Hitchmans all communications he made in his capacity as trustee of the Trust. Morgan objected to disclosing certain communications with his attorney, contending that both the attorney-client privilege and the terms of the Trust instrument barred their disclosure. The section of the Trust instrument in question provided that all communications with legal counsel "shall be absolutely protected and free from any duty or right of disclosure to any successor Trustee or any beneficiary and any duty to account."

The Probate Court held that the terms of the Trust prohibiting disclosure of all communications with legal counsel violated California public policy and entered an order compelling Morgan to disclose the privileged communications to the Hitchmans. The Probate Court's order explicitly prohibited the Hitchmans from disclosing these communications to the Shurtleffs. Morgan sought a writ of mandamus from the Fourth District Court of Appeal ("Court") stating that the Probate Court judge exceeded his authority in issuing the order.

Under California law, a trustee who seeks legal advice on behalf of a trust may assert the attorney-client privilege against a beneficiary or any third person with respect to any communications with the trustee's legal counsel. This privilege, however, vests in the office of trustee and not in the individual or entity serving as trustee. Accordingly, a former trustee must turn over all communications, including privileged communications, to a successor trustee upon request. The successor trustee can continue to assert the attorney-client privilege against the beneficiaries of the trust. A trustee who seeks legal advice regarding a charge of breach of fiduciary duty may hire a separate lawyer and pay the lawyer out of the trustee's personal funds.

Under California law, a trust instrument cannot absolve a trustee from liability for intentional misconduct, gross negligence, or reckless indifference. Privileged communications may bear on a successor trustee's determination of whether a predecessor trustee acted with intentional misconduct, gross negligence, or reckless indifference. Accordingly, a trust provision barring a predecessor trustee from disclosing privileged communications to a successor trustee is unenforceable.

The Court upheld the Probate Court's order requiring Morgan to turn over the privileged communications to the Hitchmans. The provisions of the Trust instrument barring disclosure of privileged communications to successor trustees violated California public policy and were unenforceable. Because Morgan did not distinguish between communications with his attorney on behalf of the Trust and communications with his attorney to protect himself from liability, and because Morgan paid his attorney using Trust funds, California law required him to turn over the privileged communications to the Hitchmans. Furthermore, the Probate Court correctly applied California law in barring the Hitchmans from disclosing any privileged communications to the Shurtleffs.

62. **Carberry v. Kaltschmid, 2018 WL 2731898 (Cal. 2018)**

Trust protectors do not have a general right to information allowing them to compel trust accountings

The terms of a trust provided for a "trust protector" who held certain powers in a "fiduciary capacity." The trust protector was not a beneficiary, and the trust instrument did not explicitly grant the trust protector the right to compel an accounting. The trust protector filed a probate "Petition for Order Compelling Co-Trustees to Account and to Provide Information" in the wake of a dispute between the trustees and beneficiaries that, at the time of the trust protector's petition, was in the process of being settled. No trustee or beneficiary joined or supported the trust protector's petition.

The California Probate Code requires trustees to provide accountings to the beneficiaries of a trust with a present interest in either principal or income (§ 16062(a)). Further, a trustee or beneficiary may seek a court order to compel a trustee to account to a beneficiary (§ 17200(a) & (b)(7)(C)). The California Probate Code does not grant such rights to trust protectors.

The Probate Division of the San Mateo County Superior Court denied the trust protector's petition for an accounting, ruling that the trust protector lacked standing. The trust protector appealed. The California Court of Appeal, First District, Division 5, affirmed and awarded appellate costs, but not sanctions, to the respondents.

Although California law provides trust beneficiaries with the right to compel an accounting, the trust protector was not a beneficiary of the trust. Further, the terms of the trust did not give the trust protector the right to compel an accounting. Therefore, the trust protector did not have a right to compel an accounting and lacked standing to bring his "Petition for Order Compelling Co-Trustees to Account and to Provide Information".

63. **<u>Doermer v. Oxford Fin. Grp., Ltd</u>., 884 F.3d 643, 647 (7th Cir. 2018)**

When there are multiple co-trustees, a single trustee does not have capacity to bring an action on behalf of a trust, and a beneficiary cannot sue on behalf of the trust

Richard Doermer and Kathryn Doermer Callen are the only children of Richard T. and Mary Louise Doermer. They are the beneficiaries of a multi-million dollar trust that their parents established for their benefit and the benefit of their children (the "Trust"). The Trust currently has three trustees, Richard, Kathryn, and Bankers Trust, a corporate trustee. In 2010, Richard and Kathryn had an "irreconcilable" dispute regarding how to manage and invest the Trust assets. Kathryn hired Oxford Financial Group ("Oxford"), to advise her in handling the Trust and to help resolve the problems with her brother. The Trust paid Oxford's fees.

In 2012, Oxford recommended that the co-trustees divide the Trust into two, one trust for Kathryn and her descendants and one trust for Richard and his descendants. As part of this plan, the Trust's situs was moved from Indiana to South Dakota. The siblings could not agree on how to divide the assets and Kathryn refused to sign the agreement. Richard petitioned a South Dakota state court to divide the Trust; however, the court denied the request.

In July 2016, Richard sued Oxford in Illinois state court on behalf of the Trust for breach of fiduciary duty, negligence, gross negligence and willful and wanton misconduct. Richard states that the reason Kathryn refused to sign the agreement was the negligent advice she received from Oxford. Because the Trust was not divided, Richard was unable to pursue his high-risk, high reward investment strategy. If the Trust had been divided, Richard believes his half would have earned an additional $2 million in reasonable investments opportunities. Richard sued Oxford in his capacity as both a co-trustee and a beneficiary of the Trust. The complaint identified Kathryn as an "involuntary plaintiff"; however, besides sending her a letter and a copy of the complaint, she was not joined as a party.

Oxford removed the case to federal court based on diversity jurisdiction and filed a Motion to Dismiss the Complaint. The District Court granted the Motion to Dismiss, as Richard could not sue in his capacity as co-trustee, because both state law and the trust agreement required a majority of the co-trustees to consent to the lawsuit. Additionally, Richard could not sue Oxford as a beneficiary, because state law prohibits a trust's beneficiary from suing a third party on behalf of the trust.

Richard appealed challenging both rulings and additionally arguing that the removal of the case to federal court was improper. Richard claimed the District Court lacked subject matter jurisdiction, arguing that Kathryn's presence in the case as an "involuntary plaintiff" destroyed the diversity jurisdiction that would make the removal proper.

Illinois law requires consent of a majority of the trustees to act on behalf of the trust, including filing litigation. A trust's beneficiary may not sue a third party on behalf of a trust unless the trustee could maintain an action against a third party but improperly refuses to sue.

On appeal, the United States Court of Appeals, Seventh Circuit, upheld the dismissal of the case. The Seventh Circuit first affirmed that the District Court did have valid subject matter jurisdiction because there was diversity between the plaintiff and the defendant. The Seventh Circuit evaluated the use of "involuntary plaintiff" in both Illinois (where the lawsuit was filed) and South Dakota (where the situs of the trust was located). If Kathryn was an "involuntary plaintiff" then diversity jurisdiction was destroyed, as she and Oxford are both citizens of Indiana. The Seventh Circuit stated that there is no such thing as an "involuntary plaintiff" in Illinois, and even if the case was decided under South Dakota law, an involuntary plaintiff can only arise when that person's presence is essential for proper adjudication of the case.

Richard also argued that the Trust was the real party in interest and the Trust had the citizenship of every co-trustee including Kathryn. The Court rejected this argument because when a trustee "files a lawsuit or is sued in her own name, her citizenship is all that matters for diversity purposes."

In evaluating the claims, the Seventh Circuit stated that a plaintiff's capacity to sue on behalf of a trust is determined by the state where the federal district court is located. While the Seventh Circuit used Illinois law, it stated that the outcome would not change if South Dakota law applied. The Seventh Circuit confirmed that Illinois law barred Richard from suing Oxford in his capacity as co-trustee, because state law required the consent of a majority of trustees to act on behalf of the Trust. Additionally, the Trust agreement also required a majority of co-trustees to act on behalf of the Trust and because neither the corporate trustee nor Kathryn consented to the lawsuit, Richard did not have standing to sue as a trustee.

Additionally, the Court affirmed that Richard could not sue as a beneficiary because a beneficiary may not sue a third party on behalf of a trust unless the trustee improperly refuses to file suit. An improper refusal only occurs when there is a breach of the trustee's fiduciary duties to bring the claim. Richard's Complaint did not state that either Kathryn or the corporate trustee breached any fiduciary obligation by not joining the suit and therefore failed to establish a basis allowing him to bring this suit rather than the trustees. The Seventh Circuit accordingly affirmed the dismissal of the case.

64. **Estate of Lee, 2018 WL 2374116 (Texas 2018)**

The spendthrift provisions of a testamentary trust rendered invalid, for the purposes of a standing analysis, the terms of an agreement between former beneficiaries of the trust

Testatrix Lucy Lee ("Lucy") established a testamentary trust (the "Trust") under the terms of her will (the "Will") for the lifetime benefit of her son, Jack O'Guinn ("O'Guinn"), and upon his death for the benefit of her step-grandson, Michael Douglas Lee ("Lee"), and grandson Jack Lindsay O'Guinn ("Jack"). Lucy modified her Will by a first codicil (the "First Codicil"), which named Lucy's niece, Mary Elizabeth Whitten ("Whitten") as the Trust's sole remainder beneficiary in place of Lee and Jack. Lucy later executed a second codicil (the "Second Codicil"), changing her plan and leaving her entire estate to O'Guinn outright and free of trust.

After Lucy's death, Whitten and Lee entered into an agreement (the "Agreement") pursuant to which Lee would contest probate of the Second Codicil in exchange for Whitten's promise to share 40% of her share under the First Codicil should Lee's contest of the Second Codicil be successful. The terms of the Will, republished by the First Codicil, provided that the beneficiaries held their interests subject to a spendthrift trust.

To have standing to contest a will or codicil, a party must be an "interested person," defined under Texas law as an "heir, devisee, spouse, creditor, or any other having a property right in or claim against an estate being administered" (Tex. Estates Code Ann. § 22.018(1)). Status as a former remainder beneficiary under the terms of a testamentary trust does not satisfy this definition. Further, because the spendthrift provisions of a trust may invalidate, for the purposes of a standing analysis, contractual agreements made between a trust's beneficiaries, being a party to an agreement with a trust beneficiary does not necessarily cause someone to be an "interested person" with respect to the trust or to the will that created the trust.

The County Court of Gregg County, Texas, denied Lee's petition contesting probate of the Second Codicil, ruling that Lee lacked standing. Lee appealed. The Court of Appeals of Texas, Texarkana, affirmed.

Although Lee was a former remainder beneficiary under the Trust created by the Will, this was not sufficient to give him standing to contest probate of the Second Codicil. To have standing to contest probate of the Second Codicil Lee needed an interest under either the Second Codicil, which he was contesting, or the First Codicil, which he hoped would be operative. However, Lee held no express interest under the terms of either the First Codicil or the Second Codicil. Further, Lee held no interest under the Agreement, which was invalidated by the spendthrift terms prohibiting alienation of trust assets of the Trust as outlined in the Will and as republished by the First Codicil. Therefore, Lee did not have standing to contest the Second Codicil.

65. **<u>Rachins v. Minassian,</u> 2018 WL 3387236 (Florida 2018)**

The remainder beneficiaries of a family trust were qualified beneficiaries under Florida law with standing to challenge a trust's administration, even though they would receive their interests through newly created trusts

The settlor (the "Settlor") established a trust which, at his death in 2010, when the federal estate tax was not in effect, funded a family trust (the "Family Trust") with the Settlor's entire residuary estate. The Settlor's wife (the "Wife"), who was not the mother of the settlor's children (the "Children"), had absolute discretion to make distributions from the Family Trust during her lifetime to herself for health, education, and maintenance. Upon the death of the Wife the Family Trust would terminate and the trust would be divided into separate trusts for the benefit of each of the Children. Soon after the death of the Settlor, the Children challenged the Wife's administration of the Trust for a number of reasons, including the Wife's alleged gambling habit.

The wife successfully sought dismissal of the Children's suit, claiming the Children were neither beneficiaries nor Qualified Beneficiaries of the Family Trust. The Children appealed, claiming

they are Qualified Beneficiaries under the provisions of the Florida Trust Code and, therefore, had standing to question whether the wife is properly administering the trust corpus.

Section 736.0103(16) of the Florida Trust Code states that a Qualified Beneficiary “means a living beneficiary who, on the date the beneficiary’s qualification is determined:

a. Is a distributee or permissible distributee of trust income or principal;

b. Would be a distributee or permissible distributee of trust income or principal if the interests of the distributees described in paragraph (a) terminated on that date without causing the trust to terminate; or

c. Would be a distributee or permissible distributee of trust income or principal if the trust terminated in accordance with its terms on that date.

Under Florida case law, Qualified Beneficiaries have standing to challenge the administration of a trust.

The District Court of Appeals of Florida, Fourth District, reversed holding that the Children were Qualified Beneficiaries of the Family Trust. The Children were Qualified Beneficiaries of the Family Trust with standing to challenge the administration of the Family Trust during the Wife’s lifetime, even though the Family Trust would terminate at the death of the Wife, and even though the remaining principal of the Family Trust would flow to the Children via newly created trusts rather than via outright distributions from the terminated Family Trust.

The Children are beneficiaries because they have future beneficial interest in any property remaining in the Family Trust after the Wife’s death, since any remaining property remaining in the Family Trust will be disbursed to a new trust for the Children’s benefit under the terms of the original trust document. That means because any remaining property in the Family Trust would be distributed to a new trust created for the benefit of the Children upon the Wife’s death, the Children will, at a minimum, have an equitable interest in any property in the Family Trust at that time.

The fact that any remaining principal of the Family Trust would flow into a new trust created for the Children, as opposed to being distributed to the Children outright, did not preclude the Children from being beneficiaries of the Family Trust under the statutory definition.

Similarly, the fact that the Family Trust terminated upon the Wife’s death does not preclude the Children from having a beneficial interest in the Family Trust as, by definition, a remainder interest in a trust refers to the right to receive trust property upon the termination of the trust.

The Children are also Qualified Beneficiaries of the Family Trust because the term “qualified beneficiary” includes a living beneficiary who “[w]ould be a distributee or permissible distributee of trust income or principal if the trust terminated in accordance with its terms on that date. Here, the children are qualified beneficiaries under section 736.0103(16)(c), because they would be distributes of trust principal if the Family Trust terminated in accordance with its terms (i.e., the wife died).

The District Court of Appeals found the definition of "qualified beneficiary" under subsection (16)(c) includes the Children in this situation, even though the Family Trust terminates at the wife's death and even though the Children would be distributes of any remaining trust principal in the Family Trust only through a newly-created trust for their benefit.

The District Court of Appeals concluded that the Wife's unlimited power to invade the Family Trust was subject to implied limitations to protect beneficiaries with an interest in any property that might remain in the Family upon the Wife's death which gave the Children standing to challenge the Wife's administration of the Family Trust.

65. Trudel v. SunTrust Bank, 288 F. Supp. 3d 239 (D.D.C. 2018)

Bank did not owe fiduciary duties to a deceased savings account owner. Therefore, the court denied request from the customer's children for an equitable accounting

In 1994, Ukrainian businessman Yevgenyi Scherban opened a savings account at SunTrust Bank and funded it with $1 million. Although the bank records were unclear, it appeared that Scherban named his wife, Nadejda Nikitina, and his son, Ruslan, as the beneficiaries of the account. In 1996, Scherban and Nikitina were murdered. At the time of their deaths, over $1 million remained in the account.

In December 1996, after Scherban and Nikitina's deaths, an individual posing as Nikitina asked SunTrust to wire $282,000 to an entity in the Czech Republic. Although Nikitina was deceased, the bank approved the transfer.

In 2003, the account had a zero balance and SunTrust closed the account. Neither the bank nor Scherban's children could locate withdrawal records for the remaining $812,215. Although he was a beneficiary of the account, Ruslan stated that his father's personal assistant oversaw the family's American assets, and Ruslan never received account statements.

Scherban's children suggested that SunTrust had converted the money for itself. They produced a June 2002 letter purportedly from the bank to lawyers for Nikitina's estate, which stated that there had been no customer-initiated activity on the account since Scherban opened it. However, the children also produced a statement showing an unexplained debit of $50,000 in 1997.

SunTrust, meanwhile, claimed it had no record of the letter. The Bank blamed Scherban's personal assistant for the missing funds, but it could not produce definitive evidence to support its theory.

Scherban's children sued SunTrust for an equitable accounting. After discovery, both sides moved for summary judgment.

An accounting is a general investigation of the transactions between parties. A court will grant a request for an accounting only if (1) the transaction is complex or the parties shared a fiduciary relationship and (2) the remedy at law is inadequate. Banks generally do not have a fiduciary relationship with their depositors, but one can arise if there is an established relationship of trust and confidence. A bank can create such a fiduciary relationship if it takes on additional

responsibilities, receives greater compensation than from a typical transaction or exercises excessive control.

The District Court for the District of Columbia held that the children were not entitled to an accounting for the savings account. The Bank did not provide special services nor did the children rely on SunTrust to manage or control the assets. Therefore, the Bank did not owe fiduciary duties to Scherban or the children. The District Court accordingly dismissed the children's claim for an accounting.

66. **<u>EGW v. First Federal Savings Bank of Sheridan</u>, 413 P.3d 106 (2018)**

Wyoming strongly adheres to the notion that a testator has the absolute right to dispose of his property as he sees fit at his death assuming he is legally competent to do so, and therefore *in terrorem* clauses do not violate public policy even when an action challenging such a clause is brought in good faith or is based on probable cause

Allen Willey created the Allen F. Willey Trust in 2001 (the "2001 Trust") as a revocable trust to manage his assets during his lifetime and dispose of them at his death. Mr. Willey served as trustee during his life and initially named his son, Spencer, as successor trustee. The beneficiaries of the 2001 Trust were Spencer's minor children, E.W. and A.W.

Mr. Willey amended the trust several times between 2006 and 2010 to add his wife's daughter and granddaughter as beneficiaries and to remove Spencer as a beneficiary. In 2014 another amendment to the 2001 Trust was made to remove Spencer from his role as successor trustee and to replace him with First Interstate Bank of Sheridan. Further, an *in terrorem*, or "no-contest clause", was also added to the 2001 Trust. The no-contest clause specifically stated a challenge by Spencer, Mr. Willey's grandchildren, his sisters or their children, or anyone purportedly acting on behalf of any of them shall terminate any interest they had in the 2001 Trust.

Mr. Willey entered into a listing agreement with a real estate broker in 2013 to sell the Willey Ranch, an asset of the 2001 Trust. In an attempt to prevent the sale of the ranch, Spencer filed a Complaint for Injunction and Declaratory Judgment against (1) Mr. Willey in his individual capacity and as the Trustee of the Allen F. Willey Trust, and (2) Mr. Willey's wife, Bertha. The Complaint sought to set aside the listing agreement for the ranch and remove Mr. Willey from the role of Trustee on the basis of incapacity. Spencer also alleged Bertha exercised undue influence over Mr. Willey. Spencer further asserted an oral agreement existed between his father and himself that Spencer was to inherit the Willey Ranch and therefore sale of the ranch would constitute a breach of that agreement.

Mr. Willey passed away during the proceedings. The trial court allowed Spencer's claims to proceed to trial where the jury found the trust amendments were not a product of undue influence; this verdict was appealed and affirmed by the Supreme Court of Wyoming.

In 2016, while his first action was pending, Spencer filed the current action on behalf of his two minor children, E.W. and A.W. (the "Minors"). The Minors' action sought an injunction preventing the sale of the Willey Ranch, a declaratory judgment that the *in terrorem* clause did not apply to them, removal of First Federal as Trustee and damages for First Federal's alleged breach of fiduciary duties.

First Federal Savings Bank of Sheridan, Wyoming, in its capacity as the Successor Trustee of the 2001 Trust, as amended, and Irma Bertha Willey, Susan Williams, Martin Martinez, Leslie Lube, and Brittany Phillips (the "Defendants") opposed the requested relief and moved for summary judgment on the grounds that the *in terrorem* clause voided the beneficial interests of the minors as a result of Spencer's prior lawsuit.

The Minors argued that due to Spencer's lack of standing, as determined by the trial court in the prior litigation, the *in terrorem* clause was not triggered. They also argued that the *in terrorem* clause should be declared void as a violation of public policy.

The trial court granted the Defendants' Motion for Summary Judgment. The trial court rejected the Minors' claims that Spencer had lacked standing to bring in the prior lawsuit. The trial court determined Spencer did have standing to challenge the 2010 Trust in the prior action and that challenge terminated the interests of E.W. and A.W. in the 2010 Trust. Further, the trial court determined *in terrorem* clauses do not violate Wyoming public policy.

Wyoming public policy favors an absolute right of an individual to dispose of their property as they see fit at their death. *In terrorem* clauses are enforceable regardless of the good faith or probable cause reasoning for instituting the action. The plain and unambiguous language of the document governs the interpretation of a trust agreement.

After de novo review, the Supreme Court of Wyoming affirmed the rulings of the trial court. The Supreme Court reviewed the findings of the 2014 action to confirm the trial court's decision that Spencer no longer had an interest in the 2010 Trust after the jury held there was no undue influence. There was not a decision stating Spencer lacked standing to assert that challenge.

The Wyoming Supreme Court reviewed, in depth, the public policy argument advanced by the appellants. The opinion pointed out that Wyoming courts, including the Wyoming Supreme Court, have well established precedent that states it is "the absolute right of the testator to dispose of his property after death as he sees fit, provided he is legally qualified so to do and acts as the law directs." The intent of the testator, as determined from the language of his will, controls the disposition of his property.

The Wyoming Supreme Court rejected the Minors' argument that using the action of a parent to deprive the minor child of a property right violates constitutional provisions protecting minors and providing for due process and access to courts. The Wyoming Supreme Court, relying on decisions from other jurisdictions, found that beneficiaries do not have a right to testamentary bequests and are only granted those bequests subject to the testator's conditions. Where the testator clearly states the conditions in his will, it is not up to the court to alter those conditions based on what it deems "fair".

The Wyoming Supreme Court also rejected the Minors' argument that Mr. Willey was alive at the time of the prior suit and therefore could have removed them as beneficiaries, but his failure to do so indicated he did not intend for them to be disinherited. The Wyoming Supreme Court distinguished all the cases the Minors cited to support this argument and therefore they were not persuasive to the court.

67. <u>In the Matter of the Will of E. Warren Bradway</u>, 2018 WL 3097060 (N.J. Sup. Ct. App. Div., June 25, 2018)

New Jersey court admits to probate a codicil written entirely in the purported testator's blood

From 1997 to 2004, E. Warren Bradway and Marc Coleman were in a long-term relationship. Bradway and Coleman also operated a bed and breakfast together in Philadelphia. In 2001, Bradway executed a will naming Coleman as the primary beneficiary and executor of his estate.

In 2004, Bradway and Coleman ended their relationship. Bradway also won a judgment against Coleman related to the winding up of the bed and breakfast. Later that year, Bradway began a relationship with Kirston Baylock and eventually moved into Baylock's New Jersey home.

In 2006, using his own blood as ink, Bradway drafted a codicil to his 2001 will. This codicil named Baylock as primary beneficiary and executor of his estate by directing that all references to Coleman in the 2001 will be replaced with Blaylock's name. The codicil also referenced the 2001 will and partially forgave the judgment against Coleman.

Bradway died in April 2016. The next month, Bradway's estate filed a petition to admit the 2001 will and the codicil to probate in the Chancery Division of the New Jersey Superior Court. Coleman filed an answer, claiming that the codicil was invalid.

At trial, DNA experts agreed that the blood used to write the codicil came from a full sibling of Bradway's brothers. Handwriting experts testified that the signature on the codicil matched Bradway's handwriting. However, Coleman's handwriting expert testified that the signature could have been inserted later using manual or digital "cut-and-paste" techniques.

After the expert witnesses testified, the estate moved for a directed verdict to admit the codicil to probate. Coleman opposed the motion and promised to call two witnesses who would testify that the codicil was unsigned at Bradway's death. Nonetheless, the trial court granted the estate's motion and admitted the codicil to probate. Coleman appealed.

New Jersey law recognizes traditional wills executed in accordance with testamentary formalities and holographic wills where the document is signed and the material portions are in the testator's handwriting. An unsigned document may also be admitted to probate if the proponent shows, by clear and convincing evidence, that the decedent intended the document to constitute his will, a codicil to his will, or a revocation or revival of his will or codicil.

The Appellate Division affirmed the trial court's decision to admit the codicil to probate. The appellate court first concluded, because all the handwriting experts agreed the body of the codicil was written in Bradway's handwriting, that there was clear and convincing evidence that Bradway wrote the codicil. The question then became whether there was clear and convincing evidence that Bradway intended the codicil to alter his 2001 will. On this point, the appellate court agreed that the trial court had correctly ruled there was

The appellate court ruled that the codicil's references to the 2001 will, Coleman, and the bed and breakfast debt all established that Bradway intended to amend his will. Although Bradway's use of his own blood was "eccentric", that too evidenced that Bradway intended the document to be a codicil. Therefore, the trial court did not err by admitting the codicil to probate.

68. **Horgan v. Cosden, 2018 WL 2374443 (Fla. Dist. Ct. App. May 25, 2018), review denied, No. SC18-1112, 2018 WL 3650268 (Fla. July 30, 2018)**

Early termination of a trust can only occur for the best interest of the beneficiaries when viewed in the light of the settlor's intentions

Yvonne S. Cosden created a revocable trust in 1993. This trust was amended and restated in 1998 and on January 24, 2004, as the Second Amendment to and Restatement of The Yvonne S. Cosden Revocable Trust Dated 7/29/93 (the "Trust"). Mrs. Cosden died in 2010, and the Trust became irrevocable. Joseph J. Horgan, Mrs. Cosden's personal assistant and friend, and Christopher E. Cosden, her only child, are the successor co-trustees. The Trust provides Mr. Cosden the net income for life, and upon his death, three higher educational institutions receive the principal. The Trust did not include a provision about early termination but did include a spendthrift provision.

In August 2015, Mr. Cosden and the remainder beneficiaries entered into an agreement to terminate the trust early and divide the $3 million in trust assets between them based on the actuarial value of their interests. Mr. Horgan, as co-trustee, did not agree with the early termination. In October 2015, Mr. Cosden filed a suit against Mr. Horgan, as co-trustee, seeking to terminate the Trust and a court order directing the distribution of assets in accordance with the beneficiaries' agreement. Mr. Horgan responded stating that the termination of the Trust was against the settlor's wishes to provide for her son for the rest of his life.

Both Mr. Cosden and Mr. Horgan moved for summary judgment in their favor. The Florida trial court granted summary judgment in favor of Mr. Cosden. The trial court directed termination of the Trust as provided in the agreement relying on Florida statutes that allow a court to terminate a trust if termination is not inconsistent with the settlor's purpose and is in the best interests of the beneficiaries. Mr. Horgan appealed.

Florida law allows termination of a trust when the modification or termination is not inconsistent with the settlor's purpose and the trust's purpose no longer exists, has been fulfilled, or has become illegal, impossible, wasteful, or impracticable to fulfill. A trust can also be terminated if such termination is in the best interest of the beneficiaries. However, it is not enough for the beneficiaries to all agree, rather, there must be evidence that the termination would not violate the settlor's intent.

On appeal, the Second District Court of Appeals reversed and remanded the case, directing the trial court to enter a final order of summary judgement denying the termination of the Trust.

The Second District Court of Appeals held that the plain language of the Trust determines the settlor's intent. The plain language showed Mrs. Cosden wanted to provide for her son financially

via incremental distributions of income until he died and then give the remainder to the three educational institutions. The District Court found that early termination of the Trust would frustrate these purposes of the Trust. Here, the facts did not support a finding that Trust assets were being wasted, that the purposes of the Trust had been fulfilled or that an early termination was in the best interest of the beneficiaries when considered in view of the settlor's intent.

69. **In Estate of Burkhalter, 806 S.E.2d 875 (Ga. Ct. App. 2017)**

> **The probate court finding that the petitioners' proposed declaratory judgment actions would not violate a will's terrorem clause was wrongfully decided because (1) a question regarding the validity of an *in terrorem* clause must be raised and resolved in the first declaratory judgment action raising that issue, and (2) the request for a declaration that a future petition to remove the executors would not violate the *in terrorem* clause lacked sufficient specificity for the trial court to make the required analysis that such a request would not be a violation of the *in terrorem* clause.**

The will of Louise Ray Burkhalter contained an *in terrorem* clause that read, in part, "[a]ny person … who attacks in any court of law any provision of my [will], or the administration of my estate … shall be specifically disinherited from any portion of my estate that would go to them." Louise's sons, William and John, were the executors of Louise's estate, which was probated in the Bibb County Probate Court. Two of Louise's other children, Nancy and George, filed a petition for declaratory judgement requesting a ruling that they could, without triggering the *in terrorem* clause of the will, file additional declaratory judgment actions regarding (i) the substantive provisions of the will, (ii) the *in terrorem* clause of the will, and (iii) removal of William and John as executors.

The probate court denied the declaratory judgment regarding the substantive provisions of the will, but entered a declaratory judgment permitting Nancy and George to file subsequent petitions regarding the *in terrorem* clause and to remove the executors, without triggering the *in terrorem* clause. The executors appealed.

As interpreted by case law, the Georgia Declaratory Judgment Act permits an interested party to seek a declaration concerning the validity of an *in terrorem* clause without triggering the *in terrorem* clause. Additionally, Georgia courts previously held that a declaratory judgment can be used, without triggering the *in terrorem* clause, to determine whether the proposed actions would violate the *in terrorem* clause.

On appeal, the Court of Appeals of Georgia overruled the Probate Court's decision granting the petitioners' declaratory judgment request. The Court of Appeals found no authority to support "a procedure by which an interested party may file one declaratory judgment action to determine whether it may file a second declaratory judgment action to determine the validity of an *in terrorem* clause. Rather, a question regarding the validity of an *in terrorem* clause should be resolved in the first declaratory judgment action raising that issue."

The Court of Appeals also found that the probate court improperly granted the declaratory judgment request regarding the validity of an action to remove the executors.

The Court of Appeals explained that, although an action to remove executors is not necessarily a violation of an *in terrorem* clause, the petitioners did not provide the probate court with sufficient detail regarding their proposed removal action for the probate court to properly determine whether such action would be a violation of the *in terrorem* clause. The petition did not attach a proposed complaint seeking the executors' removal or otherwise stating the basis for a suit to remove them. "Absent such allegations," the Court of Appeals held that the record was insufficient to support the conclusion of the probate court that the "… proposed Petition to remove the executors [would] not violate the *in terrorem* clause." Therefore, the Court of Appeals remanded the decision to the probate court to undertake the proper analysis.

OTHER ITEMS OF INTEREST

70. **Sveen v. Melin _____ U.S. _____ (2018)**

Supreme Court holds that retroactive application of Minnesota statute providing that the dissolution or annulment of a marriage revokes any revocable beneficiary designation made by an individual to the individual's former spouse does not violate the Contracts Clause of the Constitution

In 2002, Minnesota enacted Minn. Stat. § 524-2-804, subd. 1, that provided that the "dissolution or annulment of a marriage revokes any revocable . . . beneficiary designation . . . made by an individual to the individual's former spouse." Under this statute, if one spouse has made the other the beneficiary of a life insurance policy or similar asset, their divorce automatically revokes that designation so that the insurance proceeds will instead go to the contingent beneficiary or the policyholder's estate upon his or her death. The law did this on the theory that the policyholder would want that result. However, if the policyholder did not want this result the policyholder could rename the ex-spouse as beneficiary.

Mark Sveen and Kaye Melin were married in 1997. In 1998, Sveen purchased a life insurance policy naming Melin as the primary beneficiary and designating his two children from a prior marriage, Ashley and Antone Sveen, as contingent beneficiaries. Sveen and Melin divorced in 2007, but the divorce decree made no mention of the insurance policy and Sveen took no action to revise his beneficiary designations. Sveen passed away in 2011. Melin and the Sveen children made competing claims to the insurance proceeds.

The Sveens argued that under Minnesota's revocation and divorce law, their father's divorce cancelled Melin's beneficiary designations, leaving them as the rightful beneficiaries. Melin claimed that because the law did not exist when the policy was purchased and she was named as the primary beneficiary, the application of the later-enacted law to the insurance policy violated the Contracts Clause of the Constitution. The District Court ordered the payment of the insurance money to the Sveens, while the Eighth Circuit Reversed, holding that the retroactive application of Minnesota's law violated the Contracts Clause.

The Supreme Court in an 8 to 1 decision with Justice Gorsuch dissenting, held that the retroactive application of the Minnesota statute did not violate the Contracts Clause. It noted that the Contracts Clause restricts the power of states to disrupt contractual arrangements but it does not

prohibit all laws affecting preexisting contracts. There is a two-step test for determining when such a law crosses the Constitutional line. The test first asks whether the state law has "operated as a substantial impairment of a contractual relationship." In answering the first question, the court considers the following:

1. The extent to which the law undermines the contractual bargain;
2. The extent to which the law interferes with a party's reasonable expectations; and
3. The extent to which the law prevents the party from safeguarding or reinstating his or her rights.

If those factors show a substantial impairment, the inquiry then turns to the second test of whether the state law is drawn in an "appropriate" and "reasonable" way to "advance a significant and legitimate public purpose."

The court only looked at the first test. In its opinion, the three aspects of Minnesota's law, taken together, showed that the law did not substantially impair pre-existing contractual arrangements. First, the law is designed to reflect the policyholder's intent. Thus, it supports, rather than impairs, the contractual scheme. The law applied a prevalent legislative presumption that a divorcee would not want his or her former partner to benefit from his or her life insurance policy and other will substitutes. As a result, the law honors and does not undermine the intent of the only contracting party to care about who the beneficiaries are.

Second, the law is unlikely to disturb any policyholder's expectations at the time of contracting because an insured cannot reasonably rely on a beneficiary designation staying in place after a divorce. The court noted that divorce courts have wide discretion to divide property upon the dissolution of a marriage, including the revocation of spousal beneficiary designations and life insurance policies or mandating that such designations remain in place. A life insurance purchaser cannot know what will happen to that policy in the event of a divorce and, as a result, the purchaser's reliance interest is "next to nil." That fact cuts against providing protection under the Contracts Clause.

Finally, the law supplied a mere default rule, which the policyholder could undo at any moment. If the law's presumption about the desire of insured after divorcing is wrong, the insured could change it by sending a change of beneficiary form to the insurer. The court noted that it had long held that laws imposing such minimal paperwork burdens do not violate the Contracts Clause. Filing a change of beneficiary form is easy. And if an insured wanted his or her ex-spouse to stay as the beneficiary but did not send in the form, the result is only that the insurance is redirected to the contingent beneficiaries, not that the insured's contractual rights are extinguished.

71. **Letter Ruling 201839005 (Issued June 25, 2018; Released September 28, 2018)**

Taxpayer allowed to rollover deceased husband's state maintained retirement plan into IRA

Decedent died in 2017 and was survived by his wife and his children. The decedent was employed by a state and was a participant in a qualified plan maintained by the state. Under the terms of the plan, upon a participant's death, the plan proceeds were payable to the participant's designated beneficiary. However, if a participant lacked a valid designated beneficiary in effect at the time of death, the participant's benefit was payable to the participant's estate. In this letter ruling, the decedent did not have a designated beneficiary in effect at the time of death and the entire plan benefit was payable to the decedent's estate.

Because the decedent died intestate, his estate would have been payable to his wife and the children under state law. However, the children validly disclaimed their interest in the decedent's estate. As the result, the wife was the sole beneficiary of the estate. The wife, as the surviving spouse of the decedent and sole beneficiary of the estate, desired to cause the plan to pay the decedent's benefit to the estate and within 60 days after the date of distribution from the plan to roll the entire distribution from the plan into a IRA set up and maintained in the name of the wife. The wife sought a ruling that the proposed rollover of the plan benefit into an IRA would have no adverse income tax consequences and the amount distributed would be excluded from the wife's income.

The Service ruled that the taxpayer could rollover the plan benefit into an IRA provided that the rollover was completed within 60 days and to the extent that the amount distributed from the plan was timely rolled over to that IRA it would be excluded from income under Section 402(c)(1). Section 402(c)(1) provides generally that if any portion of an eligible rollover distribution from a qualified trust is transferred into an eligible retirement plan, the portion of the distribution so transferred shall not be includable in gross income. An IRA is an eligible retirement plan for purposes of the rollover.

72. **<u>United States v. Jan M. Mengedoht</u>, ______, F. Supp. 3d ______ (Dist. Neb. 2019)**

Court allows foreclosure for unpaid estate taxes

This case was heard on a Motion for Summary Judgment brought by the government and was a civil action to reduce tax assessments to judgment and to enforce a federal tax lien.

The government sued Jan M. Mengedoht in his individual capacity and in his official capacities as executor of the Carl M. Mengedoht Estate and as trustee of the HCJ Holdings Trust and the Washington County Treasurer in order to enforce IRS tax liens against the estate. The Washington County Treasurer and Jan Mengedoht, individually, and as trustee of the trust, were sued only so that they could protect any interest that they might claim in the property.

Carl Mengedoht died on May 29, 1998. The estate failed to file a federal estate tax return with the IRS. On April 18, 2011 the government assessed federal estate tax, penalties, and interest against

the estate. The amount due with interest and statutory additions through October 1, 2018 was over $2,700,000. The major asset of the estate, constituting more than 90 percent of the value of the estate, was real estate in Washington County, Nebraska was held in the trust. The court held that under the terms of the trust, Carl Mengedoht held the power to alter, amend, revoke or terminate the trust at the time of his death and consequently the property was part of the estate for estate tax purposes under Sections 2036 and 2037.

Neither the estate nor the trust properly appeared or answered in the suit and the court entered default judgment against them on December 12, 2017.

The remaining issue in the case was whether Jan Mengedoht had a personal interest in the real estate that was subject to the federal tax lien that attached to the real property. The court found that Jan Mengedoht had not rebutted the presumption of correctness given the assessments by the IRS. Default judgment had been entered against the trust and the estate and those entities could claim that they had an interest that would have priority to the tax liens. The government and Washington County had agreed that any real property taxes that were owed to Washington County were entitled to priority over the federal tax liens. The court found that the government's lien should be enforced in accordance with Section 7403 and the property sold. After the satisfaction of the federal tax lien, any residual proceeds would be paid to the trust. The court noted that Jan Mengedoht was deposed in the case and, when asked if he had a personal interest in the property, he refused to answer, stating "I don't want to waive my natural right to not be compelled to be a witness against myself." He refused to answer other questions on numerous subjects.

73. **Berkenfeld v. Lenet, _______ F.Supp.3d ________ (D.Md. 2018)**

Broker not liable for annuity beneficiaries taking lump sum distributions

This case was before the court on a motion for summary judgment by the defendants Claire Blumberg passed away in February 2014 at which time she owned annuities issued by Lincoln Financial and Commonwealth/Scudder. When Blumberg died, her daughters and grandson were the beneficiaries of the annuities and each elected a lump sum distribution from the annuities. Each also elected not to have federal income tax withheld from their lump sum distributions. If the daughters and grandson had elected different distribution options, they could have avoided in excess of $200,000 in overall income tax liabilities. They alleged that they elected lump sum distributions because Lenet, an advisor at Morgan Stanley, advised them that the lump sum distribution was the only distribution option. The daughters and grandson sued Morgan Stanley and Lenet in Maryland state court for negligence and breach of fiduciary duty. The defendants remanded the case to federal court. The federal court ruled in favor of the financial advisor and Lenet.

According to the court, no contract or agreement existed between the parties obligating Lenet or Morgan Stanley to give tax advice or an opinion concerning plaintiffs' available distribution options. The plaintiffs also stated that Lenet advised them to seek independent tax advice concerning their distribution options. The plaintiffs did not seek advice despite having financial advisors and tax experts at their disposal.

Each plaintiff also signed a statement in electing a lump sum disbursement for each annuity which expressly notified them of all available distributions option. Plaintiffs additionally elected not to have federal income tax withheld from their lump sum distributions despite having been warned in writing, "if you opt out of our tax withholding, you are still liable for applicable taxes on your distribution….you may want to discuss your withholding election with a qualified tax advisor."

The court found that the requirements for summary judgment were met. The party seeking summary judgment must bear the initial burden of demonstrating the absence of a genuine dispute of material fact. In reviewing a motion for summary judgment, the court must take all facts and inferences in the light most favorable to the non-moving party.

The court first examined the claims of negligence against Lenet and Morgan Stanley to see whether the defendant owed a duty to the plaintiffs, whether the defendant breached that duty, whether a causal relationship existed between the breach and the harm plaintiffs suffered, and the amount of damages.

The court stated that Lenet owed a duty of care to the plaintiffs. In addition, sufficient evidence existed to establish Lenet's breach because plaintiffs testified that Lenet erroneously advised that the lump sum distributions were the only disbursement option. Also, Lenet's advice did not conform to the standard of care that was owed to the plaintiffs. It was clear that professional standards of care required Lenet to research plaintiffs' disbursement options and advise them accordingly. As a result, Lenet's erroneous advice was negligent.

The evidence, construed most favorably to plaintiffs, also established causation. Plaintiffs showed that, but for Lenet's advice, they would not have chosen the lump sum distribution option. It was also foreseeable that plaintiffs would rely on the advice of a trusted financial advisor, the result of which was greater tax liability than that associated with the other distribution options. In addition, plaintiffs established a *prima facie* case of negligence against Lenet directly and vicariously as to Morgan Stanley. However, summary judgment was nonetheless warranted because plaintiffs was contributorily negligent.

As the court put it, this case is one in which no room for a difference of opinion exists as to the contributory negligence of the plaintiffs. Two plaintiffs had years of prior experience with annuities similar to the Lincoln and Commonwealth Scudder annuities. It was also undisputed that plaintiffs failed to exercise ordinary care to make prudent investment choices after Blumberg passed away. Despite Lenet expressly telling plaintiffs to obtain independent tax advice before electing a lump sum distribution, plaintiffs never did so even those they had professional advisors. Finally, the election form which plaintiffs used to select a lump sum distribution clearly identified all other distribution alternatives and required that plaintiffs select one. The Lincoln forms also stated, "Instructions, important information, please read carefully and completely". Defendant's motion for summary judgment was also granted on the breach of fiduciary duty count. While a breach of fiduciary duty may support a negligence or breach of contract claim it is not a stand-alone cause of action under Maryland law.

74. **Letter Ruling 201805011 (Issued November 2, 2017; Released February 2, 2018)**

IRS grants extension to waive family attribution rules

Taxpayer was a domestic individual who was treated as the owner of stock of a corporation held by a grantor trust. Members of Taxpayer's family also directly owned stock of the corporation or were treated as owning corporation stock held by separate trusts. On one date, all of Taxpayer's trust's corporation stock was redeemed for a combination of cash and promissory notes.

Taxpayer requested an extension of time to file the statement required by Treas. Reg. § 1.302-4(a) to waive the family attribution rules with respect to a redemption of the corporation's shares that is treated as a complete termination of a shareholder's interest in a corporation. Taxpayer intended to file the election, but for various reasons, the election was not filed. Under Section 318, an individual is considered to own stock owned directly or indirectly by or for his spouse, children, grandchildren, and parents (the "family attribution rules"). Section 302(c)(2) provides that Section 318 shall not apply in determining if the redemption is a complete termination of interest if:

A. Immediately after the distribution, the distributee had no interest in the corporation other than as a creditor;

B. The distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within ten years from the date of such distribution; and

C. The distributee at such time and in such manner and the distributee notifies the secretary.

This notice must be filed on or with the distributee's first return for the taxable year in which the distribution occurs. The IRS found that under Treas. Reg. § 301.9100-3, relief could be granted. The information established that Taxpayer reasonably relied on a qualified tax professional who failed to make or advise Taxpayer to make a valid election and that the request for relief was filed before the failure to make the election was discovered by the Internal Revue Service. Taxpayer showed that it acted reasonably and in good faith, and that granting relief would not prejudice the interest of the government. Thus the requirements of Treas. Reg. §§ 301.9100-1 and 301.9100-3 had been satisfied, and the extension of time was granted.

75. **United States v. Paulson, 204 F. Supp. 3d 1102 (S.D. Cal. 2018)**

Court denies defendant's motion to stay proceedings pending decision of state court

Allen Paulson established a living trust in 1986. In 1988, Allen Paulson entered into an ante-nuptial agreement with Madeleine Pickens. The ante-nuptial agreement defined their respective separate property and established certain gifts for Madeleine in the event of Allen's death. Allen subsequently amended and restated the living trust several times in early 2000 prior to his death on July 19, 2000.

The living trust gave Madeleine the power to elect between receiving property under the anti-nuptial agreement or under the living trust but not both. The living trust also created a marital trust for Madeleine's benefit. Under the terms of the living trust, the marital trust was to receive a residence and all personal property located at the residence in Rancho Santa Fe, California. The living trust also gave Madeleine the right to receive a second residence located in Del Mar, California as well as the tangible property in that residence. The marital trust also was to receive 25 percent of the residue of the living trust. The living trust named Madeleine, Michael Paulson (Allen's son), and Edward White as the co-trustees of the marital trust.

At the time of Allen's death, all of Allen's assets were held in the living trust except his shares in the Gold River Hotel and Casino Corporation. The living trust assets included approximately $24,764,500 in real estate; $113,761,706 in stocks and bonds; $23,664,644 in cash and receivables, and $31,243,494 in miscellaneous assets. Accordingly, the estate assets totaled approximately $193,434,344. Michael Paulson, served as the executor of Allen's estate. Michael Paulson also became the co-trustee of the living trust, with Edward White until White's resignation on October 8, 2001. Thereafter, Nicholas V. Diaco acted as co-trustee of the living trust with Michael Paulson.

In April 2001, the estate requested an extension of time to file the Form 706 until October 19, 2001 and an extension of time to pay taxes until October 19, 2002. Both requests for extension were granted. On October 23, 2001, the IRS received the estate's Form 706 which was signed by Michael Paulson as co-executor of the estate. In completing the tax return, the estate elected to use the alternate evaluation date of January 19, 2001. The estate reported a total gross estate of $187,726,626, a net taxable estate of $9,234,172 and an estate tax liability of $4,459,051. On November 22, 2001, the IRS assessed the reported tax of $4,459,051. The estate elected to pay part of its taxes and defer the other portion under Section 6166. Accordingly, the estate paid $706,296 as the amount not qualified for deferral, leaving a deferral balance of $3,752,755 to be paid under the Section 6166 installment election. While the estate's tax return was under review, personal disputes arose between Michael, Madeleine, and other beneficiaries. In 2003, the parties reached a settlement which was approved by the California Probate Court. Under the 2003 settlement, Madeleine forewent property under both the ante-nuptial agreement and the living trust, instead choosing to receive direct distributions from the living trust. Madeleine received the Rancho Santa Fe residence, the Del Mar residence, and the stock in the Del Mar Country Club. These distributions were made directly to Madeleine as trustee of her separate property trust. During 2004, Michael, as trustee of the living trust, distributed $5,921,888 of trust assets to various individuals.

On January 16, 2005, the IRS issued a notice of deficiency to Michael as executor of the estate which proposed a $37,801,245 deficiency in estate tax. This was argued before the tax court and the tax court determined that the estate had $6,669,477 in additional estate tax which the estate elected to pay under Section 6166. During 2006, Michael distributed an additional $1,250,000 from the living trust. In March 2009, the probate court removed Michael Paulson as trustee for misconduct. At that point, two other children of Allen, Vikki Paulson and James Paulson were appointed as co-trustees. They reported that the living trust had assets worth $13,738,727. On May 7, 2010, in response to one or more missed installment payments, the IRS issued the estate a notice of final termination, stating that the extension of time for payment under Section 6166 no

longer applied. On June 10, 2010, the probate court removed James Paulson as a co-trustee for breach of court orders. Accordingly, Vikki remained as the sole trustee of the living trust.

On August 5, 2010, the estate filed a petition in the tax court challenging the proposed termination of the Section 6166 installment payment election. On February 28, 2011, Crystal Christensen was appointed as co-trustee of the living trust. At this time, the living trust assets were worth approximately $8,802,034. In May 2011, the tax court entered a stipulated decision sustaining the IRS's decision to terminate the installment payment election. Between June 28, 2011 and July 7, 2011, the IRS reported notices of federal tax liens against the estate in the property records of San Diego and Los Angeles counties. On August 16, 2012, Vikki Paulson and Crystal Christensen, as successor trustees to the living trust, filed a petition for review of the estate's collection due process rights with the tax court. This was dismissed by the tax court on April 18, 2013 for lack of jurisdiction because Michael Paulson, who was the court-appointed executor at the time the petition was filed, did not sign the petition.

From approximately 2007 through 2013, several disputes arose between Michael, Vikki, Crystal Christensen, James, and other interested parties which were eventually settled on June 3, 2013. As a result of the 2013 settlement, Michael obtained the living trust's ownership interest in Supersonic Aerospace International LLC, the Gold River Hotel and Casino Corporation, and the Gold River Operation Corporation. As of July 10, 2015, the estate had an unpaid estate tax liability of $10,261,217. On September 16, 2015, the IRS filed a complaint seeking judgment against the estate for unpaid estate taxes and against, the defendants in either their representative or individual capacities or both for unpaid estate taxes.

As of September 16, 2015, there were several complaints against the trustees or executors for unpaid taxes and cross-claims between them. There were also several motions for summary judgment that were pending on the eve of decision in this matter.

Vikki and Crystal requested that the court stay the various motions for summary judgment while the California Probate Court heard their petition which was filed on February 13, 2018. The court noted that in determining when a stay is appropriate, it must weigh competing interest and maintain an even balance. In determining whether to grant the stay, courts considered three factors:

1. the possible damage which may result in granting the stay;

2. the hardship or inequity which a party may suffer in being required to go forward; and

3. the orderly course of justice measured in terms of the simplifying or complicating of issues, proof, and questions of law which could be expected result from a stay.

The court in looking at the request determined that the defendants would not suffer undue hardship if the action was not stayed. It then noted, that the government would be prejudiced if a stay were granted. It noted the defendants made this request nearly three years after the government first filed this action and provided no indication of when the probate court would resolve the issues. In addition, the probate petition would not simplify the issues before the court. Instead, because this case invoked the federal question, as well as issues that the federal court had been dealing with

since 2015, staying the case would be "unconstructive". As a result, all three factors weighed against the defendants' motion to stay and the motion was denied.

76. **Comptroller of the Treasury v. Taylor, 189 A.3d 799 (Md. Ct. Spec. App. July 25, 2018), In re Estate of Seiden, NYLJ 10/12/18 p. 23, col. 5 (N.Y. County Surr. Ct.)**

Maryland and New York Courts address impact of federal QTIP elections on calculation of state death taxes

The facts in these cases are simple; however, the consequences could be complex. In 1981, when Congress added Section 2056(b)(7) to the Code to permit what have become known as QTIP trusts, it seemed like such a perfect idea. Even though the trust for the surviving spouse (or donee spouse under Section 2523(f)) did not need any of the traditional features that by their terms would include the value of the trust assets in the surviving spouse's gross estate – such as a general power of appointment in the case of Sections 2056(b)(5) and 2523(e) or payment to the estate in the case of Treas. Reg. §20.2056(c)-2(b)(1)(iii) – that inclusion in the surviving spouse's gross estate was assured by the contemporaneous enactment of Section 2044, providing for inclusion whenever a marital deduction was allowed under Section 2056(b)(7) or 2523(f), backstopped by Section 2519 in the case of the surviving spouse's actions during life. Thus was maintained the fundamental character of the marital deduction as a deferral only – the asset escapes tax at the first death but is taxed at the second death. Even if the surviving spouse who is a U.S. citizen moves out of the country, Section 2001(a) continues to apply, and if such a surviving spouse with sufficient income or assets also renounces that U.S. citizenship, Sections 877 and 2107 ensure continued taxation for 10 years. Meanwhile, the 1981 objective of making the marital deduction unlimited without having to give the surviving spouse control over the disposition of the remainder is fulfilled in the QTIP trust.

Since 2001 and the three-year phase-out of the credit for state death taxes, and especially with state legislatures setting their estate tax exemptions lower than the federal basic exclusion amount, some states that still have an estate tax have provided for a state-only QTIP election, available when the estate is under the federal exclusion amount but not under the state exemption, or applicable to the extent the state exemption is less than the federal exclusion amount. But symmetry is lost to the fact that a state is powerless when the surviving spouse moves out of the state. "Worldwide," or nationwide taxation is not allowed, and, under Section 1 of the Fourteenth Amendment to the U.S. Constitution, a citizen of a state loses that citizenship merely by moving to another state. That dissymmetry is the backdrop for these cases identified as the sixth top development of 2018.

In Taylor, the predeceased spouse died domiciled in Michigan and created a trust. Both federal and Michigan QTIP elections were made. The surviving spouse moved to Maryland and died domiciled in Maryland.

The Maryland court held that Maryland cannot tax the QTIP trust because no Maryland QTIP election had been made. The court cited Code of Maryland-Tax-General §7-309(b)(6)(i) (emphasis added):

"For purposes of calculating Maryland estate tax, a decedent shall be deemed to have had a qualifying income interest for life under §2044(a) of the Internal Revenue Code with regard to any property for which a marital deduction qualified terminable interest property election was made for the decedent's predeceased spouse *on a timely filed Maryland estate tax return*."

In Seiden, the predeceased spouse died domiciled in New York in 2010, when there was no federal estate tax. But New York still had its estate tax, and a New York-only QTIP election was made. The surviving spouse did not move out of the state and died domiciled in New York.

The New York court held that New York cannot tax the QTIP trust because New York totally piggybacks on the federal gross estate, and there was no QTIP trust for federal estate tax purposes. Like the Maryland court in Taylor, the New York court relied on the New York statute, New York Tax Law §954(a), which provides that the New York gross estate of a deceased resident "means his or her federal gross estate." Because there was no federal QTIP election, the value of the trust assets was not included in the federal gross estate and hence were not included in the New York gross estate either.

The outcomes in these cases seem rather random and state-statute specific. For example, if the surviving spouse of the Michigan decedent in Taylor had moved to New York instead of Maryland, it appears that New York would tax the trust at the surviving spouse's death, because the federal QTIP election would ensure inclusion in the survivor's federal gross estate, which would then mean inclusion in the New York gross estate too.

The New York result in Seiden is not limited to surviving spouses of predeceased spouses who died in 2010. For example, if the first spouse died domiciled in New York in 2014 with a gross estate of $10 million, the federal exclusion would have been $5.34 million, and the New York exemption would have been $1 million. A reduce-to-zero marital bequest to a QTIP trust related solely to the federal estate tax would have been $4.66 million, leaving a tentative New York taxable estate of $3.66 million. New York tax could have been avoided with a New York-only QTIP election for a trust funded with $3.66 million. Upon the surviving spouse's death, in 2018 for example (assuming no changes in values), the federal gross estate would include the $4.66 million federal-QTIP trust, but not the $3.66 million New York-only-QTIP trust. A very odd result from the term "New York-only."

In addition, some states that have estate taxes may enact corrective legislation.

77. **Changes in State Death Taxes in 2018 and 2019**

Several states see changes in their state death taxes in 2018 and 2019

Numerous states either made changes or saw changes in their state death taxes as a result of the doubling of the federal estate tax applicable exclusion amount under the 2017 Tax Act.

On May 31, 2018, Connecticut changed its estate tax law to extend the phase-in of the exemption to 2023 to reflect the increase in the federal exemption to $10 million indexed for inflation in the 2017 Tax Act. The exemption will be phased in as follows:

2019: $3.6 million

2020: $5.1 million

2021: $7.1 million

2022: $9.1 million:

2023: federal exemption for deaths on or after January 1, 2023.

The District of Columbia decoupled its exemption from the federal exemption in 2018. DC Bill B22-0685 was introduced in the DC City Council on February 8, 2018 and was enacted on September 5, 2018. This law cut the DC threshold to $5.6 million indexed for inflation retroactive to January 1, 2018. The 2019 exemption was adjusted for inflation to $5,681,740.

In Hawaii, on June 7, 2018, the governor signed SB 2821, which amended HI ST § 236E-6 to reduce the Hawaiian exemption, effective January 1, 2018, to $5,000,000 indexed for inflation, which the Hawaii Department of Revenue read to be an exemption of $5,490,000 in 2018. Subsequently, for 2019, the Hawaii Department of Revenue has indicated that the Hawaii exemption will stay $5,490,000 for 2019.

Maine enacted a new law to set its exemption in 2018 at $5,600,000 indexed for inflation. Maine set its exemption at $5,700,000 for 2019.

In Maryland, on April 5, 2018, HB 0308 became law. The new law provided that for 2019 and thereafter, the Maryland threshold will be capped at the fixed amount of $5 million rather than being equal to the inflation-adjusted federal exemption as provided under prior law. The new law also provided for the portability of the unused predeceased spouse's Maryland exemption amount to the surviving spouse beginning in 2019.

New York, which was scheduled to see its exemption equal the federal exemption on January 1, 2019, will not because of the wording of its legislation. As of January 1, 2019, the New York estate tax exemption amount will be the same as the federal estate tax applicable exclusion amount prior to the 2017 Tax Act which is $5,000,000 adjusted for inflation. The maximum rate of tax will continue to be 16%. New York set its exemption for 2019 at $5,740,000.

The State of Washington's 2019 exemption was not adjusted for inflation and is the same as the 2018 exemption of $2,193,000. On December 18, 2018, the Washington Department of Revenue sent an email stating that pursuant to Revised Code of Washington (RCW) 83.100, the Department must adjust the Washington applicable estate tax exclusion amount annually using the Seattle-Tacoma-Bremerton metropolitan area October consumer price index (Seattle CPI). As of January 1, 2018, the US Bureau of Labor and Statistics (USBLS) no longer calculated the consumer price index for the Seattle-Tacoma-Bremerton metropolitan area. Instead, the USBLS now calculates the Seattle-Tacoma-Bellevue Core Based Statistical Area for the Puget Sound region. As a result

of these changes, the definition of "consumer price index" in RCW 83.100.020(1)(b) does not match with the current CPI measure calculated by the USBLS. The Department is using the last CPI figure for the Seattle CPI. This resulted in no increase in the applicable exclusion amount for 2019.

78. **2019 State Death Tax Chart (as of January 26, 2019)**

State **Type of Tax**	**Current Law**	**2019 State Death Tax Threshold**
Alabama None	Tax is tied to federal state death tax credit. AL ST § 40-15-2.	
Alaska None	Tax is tied to federal state death tax credit. AK ST § 43.31.011.	
Arizona None	Tax was tied to federal state death tax credit. AZ ST §§ 42-4051; 42-4001(2), (12). On May 8, 2006, Governor Napolitano signed SB 1170 which permanently repealed Arizona's state estate tax.	
Arkansas None	Tax is tied to federal state death tax credit. AR ST § 26-59-103; 26-59-106; 26-59-109, as amended March, 2003.	
California None	Tax is tied to federal state death tax credit. CA REV & TAX §§ 13302; 13411.	
Colorado None	Tax is tied to federal state death tax credit. CO ST §§ 39-23.5-103; 39-23.5-102.	
Connecticut Separate Estate Tax	On October 31, 2017, the Connecticut Governor signed the 2018-2019 budget which increased the exemption for the Connecticut state estate and gift tax to $2,600,000 in 2018, to $3,600,000 in	$3,600,000

State Type of Tax	Current Law	2019 State Death Tax Threshold
	2019, and to the federal estate and gift tax exemption in 2020. On May 31, 2018, Connecticut changed its estate tax law to extend the phase-in of the exemption to 2023 to reflect the increase in the federal exemption to $10 million indexed for inflation in the 2017 Tax Act. The exemption will be phased in as follows: 2019: $3.6 million 2020: $5.1 million 2021: $7.1 million 2022: $9.1 million: 2023: federal exemption for deaths on or after January 1, 2023. Beginning in 2019, the cap on the Connecticut state estate and gift tax is reduced from $20 million to $15 million (which represents the tax due on a Connecticut estate of approximately $129 million).	
Delaware None	On July 2, 2017, the Governor signed HB 16 which sunsets the Delaware Estate Tax on December 31, 2017.	

State Type of Tax	Current Law	2019 State Death Tax Threshold
District of Columbia Pick-up Only	No separate QTIP election. DC Bill B22-0685 was introduced in the DC City Council on February 8, 2018. This proposal cut the DC threshold to $5.6 million adjusted for inflation retroactive to January 1, 2018. This change was enacted by the DC City Council on September 5, 2018 as part of the Budget Support Act.	$5,681,760
Florida None	Tax is tied to federal state death tax credit. FL ST § 198.02; FL CONST. Art. VII, Sec. 5	
Georgia None	Effective July 1, 2014, the Georgia estate tax was repealed. See § 48-12-1.	
Hawaii Modified Pick-up Tax	On May 2, 2012, the Hawaii legislature passed HB 2328 which conforms the Hawaii estate tax exemption to the federal estate tax exemption for decedents dying after January 25, 2012. On June 7, 2018, the governor signed SB 2821, which amended HI ST § 236E-6 to reduce the Hawaiian exemption, effective January 1, 2018, to $5,000,000 indexed for inflation. The Hawaii Department of Taxation released Announcement 2018-13 on September 4, 2018 in which it announced that the exemption will remain at the amount available to decedents dying during 2017.	$5,490,000

State Type of Tax	Current Law	2019 State Death Tax Threshold
	In response to calls from practitioners, the Hawaii Department of Taxation indicated that was not going to adjust the exemption for inflation in 2019.	
Idaho None	Tax is tied to federal state death tax credit. ID ST §§ 14-403; 14-402; 63-3004 (as amended Mar. 2002).	
Illinois Modified Pick-up Only	On January 13, 2011, Governor Quinn signed Public Act 096-1496 which increased Illinois' individual and corporate income tax rates. Included in the Act was the reinstatement of Illinois' estate tax as of January 1, 2011 with a $2 million exemption. Senate Bill 397 passed both the Illinois House and Senate as part of the tax package for Sears and CME on December 13, 2011. It increased the exemption to $3.5 million for 2012 and $4 million for 2013 and beyond. Governor Quinn signed the legislation on December 16, 2011. Illinois permits a separate state QTIP election, effective September 8, 2009. 35 ILCS 405/2(b-1).	$4,000,000
Indiana None	Pick-up tax is tied to federal state death tax credit. IN ST §§ 6-4.1-11-2; 6-4.1-1-4. On May 11, 2013, Governor Pence signed HB 1001 which repealed Indiana's inheritance tax retroactively to January 1, 2013. This replaced Indiana's prior law enacted in 2012 which phased out Indiana's inheritance	.

State Type of Tax	Current Law	2019 State Death Tax Threshold
	tax over nine years beginning in 2013 and ending on December 31, 2021 and increased the inheritance tax exemption amounts retroactive to January 1, 2012	
Iowa Inheritance Tax	Pick-up tax is tied to federal state death tax credit. IA ST § 451.2; 451.13. Effective July 1, 2010, Iowa specifically reenacted its pick-up estate tax for decedents dying after December 31, 2010. Iowa Senate File 2380, reenacting IA ST § 451.2. Iowa has a separate inheritance tax on transfers to others than lineal ascendants and descendants.	
Kansas None	For decedents dying on or after January 1, 2007 and through December 31, 2009, Kansas had enacted a separate stand alone estate tax. KS ST § 79-15, 203	
Kentucky Inheritance Tax	Pick-up tax is tied to federal state death tax credit. KY ST § 140.130. Kentucky has not decoupled but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election.	
Louisiana None	Pick-up tax is tied to federal state death tax credit. LA R.S. §§ 47:2431; 47:2432; 47:2434.	
Maine Pick-up Only	For decedents dying after December 31, 2002, pick-up tax was frozen at pre-EGTRRA federal state death tax credit, and imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000	$5,700,000

State Type of Tax	Current Law	2019 State Death Tax Threshold
	(including scheduled increases under pre-EGTRRA law) (L.D. 1319; March 27, 2003). On June 20, 2011, Maine's governor signed Public Law Chapter 380 into law, which increased the Maine estate tax exemption to $2 million in 2013 and beyond. The rates were also changed, effective January 1, 2013, to 0% for Maine estates up to $2 million, 8% for Maine estates between $2 million and $5 million, 10 % between $ 5 million and $8 million and 12% for the excess over $8 million. On June 30, 2015, the Maine legislature overrode the Governor's veto of LD 1019, the budget bill for fiscal years 2016 and 2017. As part of the law, the Maine Exemption was tagged to the federal exemption for decedents dying on or after January 1, 2016. The tax rates are: 8% on the first $3 million above the Maine Exemption; 10% on the next $3 million above the Maine Exemption; and !2% on all amounts above $6 million above the Maine Exemption. The new legislation did not include portability as part of the Maine Estate Tax.	

State Type of Tax	Current Law	2019 State Death Tax Threshold
	On September 12, 2018, LP1655 became law without the Governor's signature. The new law amends M.R.S. Title 36, Section 4102 and Section 4119 to make the Maine exemption $5,600,000 adjusted for inflation for decedents dying on and after January 1, 2018. For estates of decedents dying after December 31, 2002, Sec. 2058 deduction is ignored in computing Maine tax and a separate state QTIP election is permitted. M.R.S. Title 36, Sec. 4062. Maine also subjects real or tangible property located in Maine that is transferred to a trust, limited liability company or other pass-through entity to tax in a non-resident's estate. M.R.S. Title 36, Sec. 4064.	
Maryland Pick-up Tax Inheritance Tax	On May 15, 2014, Governor O'Malley signed HB 739 which repealed and reenacted MD TAX GENERAL §§ 7-305, 7-309(a), and 7-309(b) to do the following: 1. Increased the threshold for the Maryland estate tax to $1.5 million in 2015, $2 million in 2016, $3 million in 2017, and $4 million in 2018. For 2019 and beyond, the Maryland threshold will equal the federal applicable exclusion amount.	$5,000,000

State Type of Tax	Current Law	2019 State Death Tax Threshold
	2. Continued to limit the amount of the federal credit used to calculate the Maryland estate tax to 16% of the amount by which the decedent's taxable estate exceeds the Maryland threshold unless the Section 2011 federal state death tax credit is then in effect. 3. Continued to ignore the federal deduction for state death taxes under Sec. 2058 in computing Maryland estate tax, thus eliminating a circular computation. 4. Permitted a state QTIP election. On April 5, 2018, HB 0308 became law. The new law provides that for 2019 and thereafter, the Maryland threshold will be capped at the fixed amount of $5 million rather than being equal to the inflation-adjusted federal exemption as provided under prior law. The new law also provides for the portability of the unused predeceased spouse's Maryland exemption amount to the surviving spouse beginning in 2019.	
Massachusetts Pick-up Only	For decedents dying in 2002, pick-up tax is tied to federal state death tax credit. MA ST 65C §§ 2A. For decedents dying on or after January 1, 2003, pick-up tax is frozen at federal state death tax credit in effect on	$1,000,000

State Type of Tax	Current Law	2019 State Death Tax Threshold
	December 31, 2000. MA ST 65C §§ 2A(a), as amended July 2002. Tax imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. See, Taxpayer Advisory Bulletin (Dec. 2002), DOR Directive 03-02, Mass. Guide to Estate Taxes (2003) and TIR 02-18 published by Mass. Dept. of Rev. Massachusetts Department of Revenue has issued directive, pursuant to which separate Massachusetts QTIP election can be made when applying state's new estate tax based upon pre-EGTRRA federal state death tax credit.	
Michigan None	Tax is tied to federal state death tax credit. MI ST §§ 205.232; 205.256	
Minnesota Pick-up Only	Tax frozen at federal state death tax credit in effect on December 31, 2000, clarifying statute passed May 2002. Tax imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. MN ST §§ 291.005; 291.03; instructions for MN Estate Tax Return; MN Revenue Notice 02-16.	$2,700,000

State Type of Tax	Current Law	2019 State Death Tax Threshold
	Separate state QTIP election permitted. On May 30, 2017, the governor signed the budget bill, H.F. No. 1 which increased the Minnesota estate tax exemption for 2017 from $1,800,000 to $2,100,000 retroactively, and increases the exemption to $2,400,000 in 2018, $2,700,000 in 2019, and $3,000,000 for 2020 and thereafter. A provision enacted in 2013 to impose an estate tax on non-residents who own an interest in a pass-through entity which in turn owned real or personal property in Minnesota was amended in 2014 to exclude certain publicly traded entities. It still applies to entities taxed as partnerships or S Corporations that own closely held businesses, farms, and cabins.	
Mississippi None	Tax is tied to federal state death tax credit. MS ST § 27-9-5.	
Missouri None	Tax is tied to federal state death tax credit. MO ST §§ 145.011; 145.091.	
Montana None	Tax is tied to federal state death tax credit. MT ST § 72-16-904; 72-16-905.	

State Type of Tax	Current Law	2019 State Death Tax Threshold
Nebraska County Inheritance Tax	Nebraska through 2006 imposed a pick-up tax at the state level. Counties impose and collect a separate inheritance tax. NEB REV ST § 77-2101.01(1).	
Nevada None	Tax is tied to federal state death tax credit. NV ST Title 32 §§ 375A.025; 375A.100.	
New Hampshire None	Tax is tied to federal state death tax credit. NH ST §§ 87:1; 87:7.	
New Jersey Inheritance Tax	On October 14, Governor Christie signed Assembly Bill A-12 which was the tax bill accompanying Assembly Bill A-10 which revised the funding for the state's Transportation Fund. Under this law, the Pick-Up Tax had a $2 million exemption in 2017 and was eliminated as of January 1, 2018. The new law also eliminated the tax on New Jersey real and tangible property of a non-resident decedent. The repeal of the pick-up tax did not apply to the separate New Jersey inheritance tax.	.
New Mexico None	Tax is tied to federal state death tax credit. NM ST §§ 7-7-2; 7-7-3.	
New York Pick-up Only	The Executive Budget of 2014-2015 which was signed by Governor Cuomo on March 31, 2014 made substantial changes to New York's estate tax.	$5,740,000

State Type of Tax	Current Law	2019 State Death Tax Threshold
	The New York estate tax exemption which was $1,000,000 through March 31, 2014 was increased as follows: April 1, 2014 to March 31, 2015 -- $2,062,500 April 1, 2015 to March 31, 2016 -- $3,125,000 April 1, 2016 to March 31, 2017 -- $4,187,500 April 1, 2017 to December 31, 2018 -- $5,250,000 As of January 1, 2019, the New York estate tax exemption amount will be the same as the federal estate tax applicable exclusion amount **prior** to the 2017 Tax Act which is $5,000,000 adjusted for inflation. The maximum rate of tax will continue to be 16%. Taxable gifts within three years of death between April 1, 2014 and December 31, 2018 will be added back to a decedent's estate for purposes of calculating the New York tax. The New York estate tax is a cliff tax. If the value of the estate is more than 105% of the then current exemption, the exemption will not be available. On April 1, 2015, as part of 2015-2016 Executive Budget, New York enacted	

State Type of Tax	Current Law	2019 State Death Tax Threshold
	changes to the New York Estate Tax. New York first clarified that the new rate schedule enacted in 2014 applies to all decedents dying after April 1, 2014. Previously, the rate schedule only applied through March 31, 2015. New York then modified the three year gift add-back provision to make it clear that the gift add-back does not apply to any individuals dying on or after January 1, 2019. Previously, the gift add-back provision did not apply to gifts made on or after January 1, 2019. New York continues not to permit portability for New York estates and no separate state QTIP election is allowed when portability is elected on a federal return.	
North Carolina None	On July 23, 2013, the Governor signed HB 998 which repealed the North Carolina estate tax retroactively to January 1, 2013.	
North Dakota None	Tax is tied to federal state death tax credit. ND ST § 57-37.1-04	
Ohio None	Governor Taft signed the budget bill, 2005 HB 66, repealing the Ohio estate (sponge) tax prospectively and granting credit for it retroactively. This was effective June 30, 2005 and killed the sponge tax. On June 30, 2011, Governor Kasich signed HB 153, the biannual budget bill, which contained a repeal of the	

State Type of Tax	Current Law	2019 State Death Tax Threshold
	Ohio state estate tax effective January 1, 2013.	
Oklahoma None	Tax is tied to federal state death tax credit. OK ST Title 68 § 804 The separate estate tax was phased out as of January 1, 2010.	
Oregon Separate Estate Tax	On June 28, 2011, Oregon's governor signed HB 2541 which replaced Oregon's pick-up tax with a stand-alone estate tax effective January 1, 2012. The new tax has a $1 million threshold with rates increasing from ten percent to sixteen percent between $1 million and $9.5 million. Determination of the estate for Oregon estate tax purposes is based upon the federal taxable estate with adjustments.	$1,000,000
Pennsylvania Inheritance Tax	Tax is tied to the federal state death tax credit to the extent that the available federal state death tax credit exceeds the state inheritance tax. PA ST T. 72 P.S. § 9117 amended December 23, 2003. Pennsylvania had decoupled its pick-up tax in 2002, but has now recoupled retroactively. The recoupling does not affect the Pennsylvania inheritance tax which is independent of the federal state death tax credit. Pennsylvania recognizes a state QTIP election.	
Rhode Island	Tax frozen at federal state death tax credit in effect on January 1, 2001,	$1,561,719

State Type of Tax	Current Law	2019 State Death Tax Threshold
Pick-up Only	with certain adjustments (see below). RI ST § 44-22-1.1. Rhode Island recognized a separate state QTIP election in the State's Tax Division Ruling Request No. 2003-03. Rhode Island's Governor signed into law HB 5983 on June 30, 2009, effective for deaths occurring on or after January 1, 2010, an increase in the amount exempt from Rhode Island estate tax from $675,000, to $850,000, with annual adjustments beginning for deaths occurring on or after January 1, 2011 based on "the percentage of increase in the Consumer Price Index for all Urban Consumers (CPI-U). . . rounded up to the nearest five dollar ($5.00) increment." RI ST § 44-22-1.1. On June 19, 2014, the Rhode Island Governor approved changes to the Rhode Island Estate Tax by increasing the exemption to $1,500,000 indexed for inflation in 2015 and eliminating the cliff tax.	
South Carolina None	Tax is tied to federal state death tax credit. SC ST §§ 12-16-510; 12-16-20 and 12-6-40, amended in 2002.	
South Dakota None	Tax is tied to federal state death tax credit. SD ST §§ 10-40A-3; 10-40A-1 (as amended Feb. 2002).	
Tennessee None	Pick-up tax is tied to federal state death tax credit. TN ST §§ 67-8-202; 67-8-203.	

State Type of Tax	Current Law	2019 State Death Tax Threshold
	Tennessee had a separate inheritance tax which was phased out as of January 1, 2016.	
Texas None	Tax was permanently repealed effective as of September 15, 2015 when Chapter 211 of the Texas Tax Code was repealed. Prior to September 15, 2015, the tax was tied to the federal state death tax credit.	
Utah None	Tax is tied to federal state death tax credit. UT ST § 59-11-102; 59-11-103.	
Vermont Modified Pick-up	In 2010, Vermont increased the estate tax exemption threshold from $2,000,000 to $2,750,000 for decedents dying January 1, 2011. As of January 1, 2012 the exclusion is scheduled to equal the federal estate tax applicable exclusion, so long as the FET exclusion is not less than $2,000,000 and not more than $3,500,000. VT ST T. 32 § 7442a. Previously the estate tax was frozen at federal state death tax credit in effect on January 1, 2001. VT ST T. 32 §§ 7402(8), 7442a, 7475, amended on June 21, 2002. No separate state QTIP election permitted.	$2,750,000
Virginia None	Tax is tied to federal state death tax credit. VA ST §§ 58.1-901; 58.1-902.	

State Type of Tax	Current Law	2019 State Death Tax Threshold
	The Virginia tax was repealed effective July 1, 2007. Previously, the tax was frozen at federal state death tax credit in effect on January 1, 1978. Tax was imposed only on estates exceeding EGTRRA federal applicable exclusion amount. VA ST §§ 58.1-901; 58.1-902.	
Washington Separate Estate Tax	LEGISLATIVE FRAMEWORK. On February 3, 2005, the Washington State Supreme Court unanimously held that Washington's state death tax was unconstitutional. The tax was tied to the current federal state death tax credit, thus reducing the tax for the years 2002 - 2004 and eliminating it for the years 2005 - 2010. Hemphill v. State Department of Revenue 2005 WL 240940 (Wash. 2005). In response to Hemphill, the Washington State Senate on April 19 and the Washington House on April 22, 2005, by narrow majorities, passed a stand-alone state estate tax with rates ranging from 10% to 19%, a $1.5 million exemption in 2005 and $2 million thereafter, and a deduction for farms for which a Sec. 2032A election could have been taken (regardless of whether the election is made). The Governor signed the legislation. WA ST §§ 83.100.040; 83.100.020. Washington voters defeated a referendum to repeal the Washington estate tax in the November 2006 elections. On June 14, 2013, Governor Inslee signed HB 2075 which closed an	$2,193,000

State Type of Tax	Current Law	2019 State Death Tax Threshold
	exemption for marital trusts retroactively immediately prior to when the Department of Revenue was about to start issuing refund checks, created a deduction for up to $2.5 million for certain family owned businesses and indexes the $2 million Washington state death tax threshold for inflation. SEPARATE QTIP ELECTION. Washington permits a separate state QTIP election. WA ST §83.100.047. NO INDEXING FOR INLFATION IN 2019. Washington State was supposed to index the exemption annually for inflation. However, this was not done for 2019. On December 18, 2018, the Department of Revenue sent an email stating that pursuant to Revised Code of Washington (RCW) 83.100, the Department must adjust the Washington applicable estate tax exclusion amount annually using the Seattle-Tacoma-Bremerton metropolitan area October consumer price index (Seattle CPI). As of January 1, 2018, the US Bureau of Labor and Statistics (USBLS) no longer calculates the consumer price index for the Seattle-Tacoma-Bremerton metropolitan area. Instead, the USBLS will calculate the Seattle-Tacoma-Bellevue Core Based Statistical Area for the Puget Sound region.	

State Type of Tax	Current Law	2019 State Death Tax Threshold
	As a result of these changes, the definition of "consumer price index" in RCW 83.100.020(1)(b) does not match with the current CPI measure calculated by the USBLS. The Department is using the last CPI figure for the Seattle CPI. This resulted in no increase in the applicable exclusion amount for 2019.	
West Virginia None	Tax is tied to federal state death tax credit. WV § 11-11-3.	
Wisconsin None	Tax is tied to federal state death tax credit. WI ST § 72.01(11m). For deaths occurring after September 30, 2002, and before January 1, 2008, tax was frozen at federal state death tax credit in effect on December 31, 2000 and was imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount. Thereafter, tax imposed only on estates exceeding EGTRRA federal applicable exclusion amount. WI ST §§ 72.01; 72.02, amended in 2001; WI Dept. of Revenue website. On April 15, 2004, the Wisconsin governor signed 2003 Wis. Act 258, which provided that Wisconsin will not	

State Type of Tax	Current Law	2019 State Death Tax Threshold
	impose an estate tax with respect to the intangible personal property of a non-resident decedent that has a taxable situs in Wisconsin even if the non-resident's state of domicile does not impose a death tax. Previously, Wisconsin would impose an estate tax with respect to the intangible personal property of a non-resident decedent that had a taxable situs in Wisconsin if the state of domicile of the non-resident had no state death tax.	
Wyoming None	Tax is tied to federal state death tax credit. WY ST §§ 39-19-103; 39-19-104.	

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Briefing

What Should a Married Couple's Estate Plan Be Post-2017?

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What Should a Married Couple's Estate Plan Be Post-2017?

I. Introduction

A. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 and the American Taxpayer Relief Act of 2012 changed the dynamics of transfer tax planning for the vast majority of wealthy taxpayers. The Acts increased the exclusion amount for estate, gift and generation-skipping tax purposes to $5,000,000 and then made the increase permanent. They also added portability of the exclusion, providing a way to transfer unused gift and estate tax exclusion to the surviving spouse.

B. The Tax and Jobs Act of 2017 implemented a doubling of the exclusion amount, to $11,180,000 in 2018. The change is only temporary, however, with this provision expiring at the end of 2025. In 2019, the exclusion amount increased to $11,400,000 per person.

C. A 2010 Congressional Research Service Report noted that even with a $5,000,000 exemption, the number of taxable estates measured as a percentage of deaths on an annual basis was projected to be 0.14% (citing projections based on U.S. Census Bureau data). This is far below the recent historical levels of 1% to 2% of decedent's estates having to pay estate taxes. At least through 2025, the percentage of estate tax paying estates will be well under 0.10%.

D. The current transfer tax law leaves the under $10 million married client with a number of difficult issues.

1. Is transfer tax planning necessary at all, or do the high exclusions and portability eliminate the need for such tax planning altogether?

2. If marital/nonmarital planning still is advisable, what is the best way to utilize the applicable exclusion amount, through traditional planning, reliance on portability, or a combination of the two?

3. What is the best way to do generation-skipping transfer ("GST") tax planning?

4. How can the clients use some of the applicable exclusion amount for gifts, without compromising their financial well-being?

5. What are the income tax ramifications of these various options?

E. Couples with more than $10 million of wealth face many of the same issues.

1. Those with more than $10 million face the added concern that estate taxes will have an impact on their planning if the current exclusion amounts expire at the end of 2025.

2. For some portability may be a better option than traditional planning.

3. Whether it is true or not, they may believe that lifetime gifts using the applicable exclusion may threaten their financial well-being.

4. Income tax rates play a more prominent role in all their planning issues.

II. A Short History of the Estate Tax Exclusion and Planning to Utilize It

A. Key Developments in the Unified Transfer Tax System

1. Since enactment of the Tax Reform Act of 1976, the federal estate and gift taxes have been assessed using a single tax rate table under which all lifetime taxable transfers and all taxable transfers at death are considered together. The 1976 Act also added Section 2010 to the Internal Revenue Code (the "Code") creating a unified credit against the estate and gift taxes that exempts a certain amount of property from the tax. The credit is now identified in the Code as the applicable credit amount. The amount sheltered by the credit is the applicable exclusion amount. IRC § 2010(a), (c).

2. The Economic Recovery Tax Act of 1981 brought about the unlimited marital deduction, in effect enacting a policy that the federal government would expect payment of estate tax only once for a married couple. A couple could choose to defer estate tax until the death of the survivor by leaving property at the death of the first spouse to die to the surviving spouse.

3. These two changes to the estate tax system left married couples with a choice. They could take the easy route, leave all property at the first death to the surviving spouse, and defer but not necessarily avoid or minimize estate tax. Or they could create a separate credit shelter trust to utilize the first spouse's exclusion amount. Most couples with knowledgeable counsel chose the latter option. The A/B estate plan with an optimum marital deduction, as we know it today, became an integral part of estate planning.

4. In separate property states, the retitling of assets in order to use the exclusion regardless of the order of deaths also became part of planning. It was less of an issue at first because of the size of the exclusion. With increases to the exclusion over time, it has become an increasingly challenging part of marital planning.

5. In 1977, the unified credit and effective exclusion amounts were $30,000 and $131,000. By 2001, the credit had increased to $220,550, which sheltered $675,000. The exclusion amount increased to $1,000,000 in 2002.

6. The applicable exclusion amount for 2009, the last year before the one year repeal of the estate tax in 2010, was $3,500,000. The applicable credit amount was $1,455,800.

B. The history of the applicable exclusion amount since 2010 is as follows:

Applicable Year	Applicable Credit Amount	Applicable Exclusion Amount
2011	$1,730,800	$5,000,000
2012	$1,772,800	$5,120,000
2013	$2,045,800	$5,250,000
2014	$2,081,800	$5,340,000
2015	$2,117,800	$5,430,000
2016	$2,125,800	$5,450,000
2017	$2,141,800	$5,490,000
2018	$4,417,800	$11,180,000
2019	$4,505,800	$11,400,000

III. Impact of the Changes on Planning

A. In the early 2000's and before, any couple who had accumulated more than $1,000,000 of assets faced the possibility of estate tax.

1. In order to avoid or minimize the estate tax, it was necessary to utilize the exclusion of the first spouse to die.

EXAMPLE: John dies in 2002 with an estate of $1,000,000. He leaves all the property to his wife, Jane. Jane has $500,000 of her own assets. Jane dies in 2003. Her $1,500,000 estate exceeds her $1,000,000 exclusion. Her estate owes estate tax of $210,000.

EXAMPLE: John dies in 2002 with an estate of $1,000,000. The property passes to a credit shelter trust for Jane. Jane has $500,000 of her own assets. Jane dies in 2003. Only her $500,000 of assets are included in her estate. No estate tax is due.

2. In separate property states, the retitling of assets in order to use the exclusion regardless of the order of deaths was part of planning. If John

and Jane owned all their assets in joint tenancy, John's exclusion might not be used at the first death, even with a credit shelter trust.

3. Many clients are reluctant to retitle assets to accommodate future use of the exclusion. There are two overlapping challenges in convincing clients that a more equal division of assets is worthwhile.

    a. First, the spouse with the larger estate may not want to give assets to his or her spouse for personal reasons. These doubts may arise from concern over possible divorce, the spouse's spending habits, or for other reasons.

    b. Second, the couple may strongly oppose the administrative inconvenience of creating separate accounts.

B. A couple in 2002 with $6,000,000 of assets was not going to avoid estate tax by using credit shelter planning. But there was a significant savings to using such planning, and therefore a high motivation to use it.

EXAMPLE: Jane dies in 2002 with an estate of $4,000,000. If she left all her estate to John and he had $2,000,000 of his own property, his $6,000,000 estate would owe estate tax of $2,395,000 in 2003.

EXAMPLE: If Jane set aside $1,000,000 in a credit shelter trust. John's estate would be $5,000,000 at his death. The estate tax was $1,905,000. The savings was $490,000.

C. If the $6,000,000 estate of Jane and John grew from 2002 to 2019 at the average rate of inflation, today they would have $8,430,600. They remain quite wealthy. But not in the eyes of the federal estate tax.

1. If all their assets pass to the survivor, there would be no federal estate tax in the survivor's estate in 2019. The A/B plan is not necessary.

2. Even if the applicable exclusion reverted in the next couple of years to around $5.7 or $5.8 million, if the executor of the first spouse to die elects portability, the federal estate tax for the survivor will be zero.

D. This does not mean, however, that credit shelter trust planning is never relevant for couples whose estate are less than twice the exclusion amount. As discussed below, a variety of other factors must be considered.

E. The biggest challenge in planning after the Tax and Jobs Act of 2017 is the uncertainty about what the applicable exclusion amount will be in the future.

1. Most wealth planners believe that an estate plan must contemplate the currently planned reduction in the exclusion amount at the end of 2025,

even if they believe Congress is likely to follow the historical trend and not allow the exclusion to decrease.

2. A change in power in Washington could mean the reduction in the exclusion would occur as early as 2021.

3. There are Democrat supported proposals on a regular basis to return to a $3,500,000 exclusion. This seems less likely, but an estate plan that contemplates use if both of married couple's exclusions would continue to work even with a much lower exclusion amount.

F. General Tips for a Married Couple's Plan

1. Determine if a traditional A/B plan or portability planning is more appropriate for the client's situation. This decision will involve a large number of factors, discussed in this outline.

2. Determine to what extent trusts are needed, separate and apart from the tax planning. The size of the estate, ages of the couple and length of marriage, ages of children and grandchildren, and capabilities, risk profile of the beneficiaries all will be factors.

3. Are there special assets or special family circumstances that will need to be addressed? Does the estate plan have to be coordinated with other family estate planning (existing trusts or family entities)?

4. Who are candidates to serve as fiduciaries?

5. What flexibility is desirable to allow the future fiduciaries or family members to change the plan (powers of appointment; provisions to cause excluded assets to be included for estate tax purposes; decanting authority).

6. Once the foundation of a testamentary plan is in place, what lifetime transfer tax planning is advisable.

IV. Portability Provisions

A. What Portability Is

1. Portability refers to the transferability of the applicable exclusion amount. It allows a surviving spouse to use the applicable exclusion amount that remains unused at the death of his or her predeceased spouse, in addition to his or her own applicable exclusion amount.

EXAMPLE: Janet Jones died in 2017, and a total of $1,490,000 of assets passed under her estate plan to a nonmarital trust for her husband, John

Jones. Janet's executor elected to have her $4,000,000 of unused exclusion amount transferred to John. If John took no further action and died in 2019, he would have a total of $15,400,000 of applicable exclusion amount ($4,000,000 plus his own $11,400,000 2019 exclusion) that could shelter property from estate tax.

2. Portability was intended to simplify estate planning by eliminating the need for a married couple to create a credit shelter trust at the first death in order to use the exclusion. It also allows couples to avoid the retitling of assets that often was necessary in traditional credit shelter trust planning in order to maximize use of the applicable exclusion at the first death. This planning often required couples to forego the convenience of joint investment accounts and to balance ownership of their assets between them.

3. The primary intended benefactors of portability are couples whose combined assets are, or are expected to be, greater than one exclusion amount but less than two times the exclusion amount (about $6,000,000 to $11,000,000, or $12,000,000 to $22,000,000 for 2019 to 2025). With traditional estate planning, a couple with wealth in this range who split ownership of their assets between them still usually would leave some applicable exclusion unused at the first death.

B. Basic Provisions and Scope

1. Section 2010 of the Code, as amended by Sections 302(a)(1) and 303(a) of the Tax Relief Act of 2010, created portability by introducing the concept of "deceased spousal unused exclusion amount" ("DSUE amount"). Section 2010(c)(2) defines the applicable exclusion amount as "the sum of (A) the basic exclusion amount, and (B) in the case of a surviving spouse, the deceased spousal unused exclusion amount."

2. Portability is available without regard to the size of the estate of the decedent or the reason for the decedent having unused exclusion amount.

   a. A 2017 decedent with a $2 million estate, all left in taxable form, leaves $3.49 million of DSUE amount.

   b. A 2017 decedent with an $18 million estate, who leaves $2 million to his children and $16 million to his spouse and charity, also leaves $3.49 million of DSUE amount.

3. The definition of applicable exclusion amount also applies for gift tax purposes. The 2010 Act amended Code Section 2505 (Unified Credit Against Gift Tax) to define the credit for gift tax purposes by reference to "the applicable credit amount in effect under section 2010(c) which would apply if the decedent died as of the end of the calendar year." Thus, a

surviving spouse may use his or her enhanced applicable exclusion amount for gifts.

4. Portability does not apply to the GST exemption. Section 2631(c), as amended by the 2010 Act, defines the GST exemption amount as equal to "the basic exclusion amount under section 2010(c)."

5. While the basic exclusion amount is adjusted for inflation, the DSUE amount is not adjusted for inflation once transferred to the surviving spouse.

6. By statute, portability must be elected by the deceased spouse's executor on a timely filed Form 706 for the deceased spouse. IRC § 2010(c)(5).

7. The statute limits the surviving spouse to use of the unused exclusion of his or her last deceased spouse. This limitation applies regardless of whether the last deceased spouse has any unused exclusion or whether the last deceased spouse's executor makes or fails to make a timely election. Thus, an individual can lose DSUE amount if he or she remarries and his or her second spouse also dies first.

    a. Under the regulations governing use of applicable exclusion for lifetime gifts, a surviving spouse can preserve DSUE amount by making taxable gifts. The gifts will use DSUE amount first, and that use is not lost if the spouse remarries and survives another spouse.

    b. These ordering rules clearly are a benefit to high net worth individuals. However, in estates of $6,000,000 to $12,000,000, the spouse may be less able, or less willing, to make significant lifetime gifts.

C. Election

1. The surviving spouse may use the unused exclusion amount of a deceased spouse only if the executor of the deceased spouse timely files a Form 706 for the deceased spouse and elects to make that spouse's unused exclusion portable. IRC § 2010(c)(5); Treas. Reg. § 20.2010-2(a)(2). The regulations make clear that the return must be filed by the nine month due date unless an extension request is timely made. Treas. Reg. §20.2010-2(a)(1).

2. The last timely-filed return is determinative of whether the election is made and that election is irrevocable. The regulations do not provide a procedure for a protective election.

a. Section 2010(c)(5) states "No election may be made under this subparagraph if such return is filed after the time prescribed by law (including extensions) for such return."

b. The Internal Revenue Code does not prescribe a time for filing a return for an estate that is below the threshold for filing an estate tax return, because there is no filing requirement. The regulations issued under Section 2010 fill this gap.

c. Because the filing deadline for estates under the filing threshold is imposed by the regulations, not statute, estates under the threshold are able to apply for relief for a missed election under Treas. Reg. §301.9100-3. The IRS confirmed this interpretation in Rev. Proc. 2014-18 (issued January 27, 2014), and the final regulations refer to it. Treas. Reg. §20.2010-2(a)(1). Relief under § 301.9100-3 requires a private letter ruling request.

d. Letter Ruling 201407002 (Nov. 4, 2013) illustrates the use of § 301.9100-3 to obtain relief for a missed portability election. The decedent's estate was less than the basic exclusion amount, so the estate was not required to file an estate tax return under Code Section 6018. The estate failed to file the return in a timely manner to elect portability and now was asking for an extension of time to make the portability election. The IRS granted an extension of time to file the Form 706.

e. Similar relief is not available for an estate over the filing threshold. Of course, unless the taxpayer missed the filing of the Form 706 entirely, the only relief sought in most cases would be to elect out of portability. The filing of the return constitutes an election to make the DSUE amount portable.

V. Analysis of the Use of Portability versus Credit Shelter Planning

A. Increased Applicable Exclusion

1. The single biggest development impacting planning with portability, in fact all estate planning, was the increase in the applicable exclusion amount to $5,000,000 indexed.

a. As a result of the $5,000,000 exclusion, a significant portion of the "millionaire population" that traditionally were subject to estate tax no longer have to worry about the tax.

b. That portion has increased with the inflation adjustment to the exclusion, and, at least temporarily, with the doubling of the

exclusion starting in 2018. Many retired couples with medium sized estates eventually move into a consumption mode, where their inflation-adjusted, if not their real, net worth starts to go down. Meanwhile, the exclusion amount will increase, by at least $75,000 to $150,000 per year given current inflation rates.

c. The following table shows the projected applicable exclusion amount at two different inflation rates, starting with the 2019 base of $11,400,000. It also shows the amounts of the exclusion if it reverts to the lower levels.

	2017 Tax Act		Assume 2025 Sunset	
Year	1.5%	3%	1.5%	3%
2019	$11,400,000	$11,400,000	-	-
2025	$12,440,000	$13,590,000	-	-
2026	$12,620,000	$13,990,000	$6,290,000	$6,980,000
2030	$13,370,000	$15,720,000	$6,650,000	$7,830,000

2. Combined with portability, the increasing applicable exclusion amount means that many married couples will stay safely under the threshold for paying federal estate tax.

In fact, even for couples whose estates are significantly larger than twice the exclusion amount, the probability of paying estate tax will decrease over time if they have a high spending rate. Using the $5,000,000 base exclusion, Bernstein Global Wealth Management has run projections of the likelihood of paying estate tax for hypothetical couples in California and New York with a current net worth of $20 million who are spending at the rates indicated:[1]

Probability of a Federal Estate Tax Liability (Current $20 Mil. California Residents)		
Spending	Year 10	Year 20
3% ($600k)	94%	72%
4% ($800k)	87%	46%
5% ($1 mil.)	74%	22%

Probability of a Federal Estate Tax Liability (Current $20 Mil. New York City Residents)		
Spending	Year 10	Year 20
3% ($600k)	94%	68%
4% ($800k)	86%	41%

[1] Paul S. Lee, "Venn Diagrams: Meet Me at the Intersection of Estate and Income Tax," 48th Annual Heckerling Institute on Estate Planning, at 2-17 (2014).

5% ($1 mil.)	71%	18%

B. Advantages of Portability

1. Simplicity. As previously discussed, the main advantage of portability is simplicity. It allows a married couple to prepare a simple estate plan that leaves all property to the surviving spouse (in trust or outright), while still preserving the deceased spouse's applicable exclusion amount.

   a. This is an advantage in particular for couples whose combined estates are under the applicable exclusion amount. The couple also can avoid the administrative inconvenience of dividing assets between them, and retitling assets in order to preserve use of the exclusion amount.

   b. Many couples whose estates are under twice the exclusion amount also will want to take advantage of this simplicity. There is the risk of losing the DSUE amount and incurring some estate tax if the surviving spouse remarries and the second spouse also predeceases him or her, but for many clients this risk is minimal.

2. Additional Basis Step-Up. The primary tax benefit of portability is that assets passing to the surviving spouse will receive another step-up in basis at the surviving spouse's death, something not available for assets in a credit shelter trust.

   a. In estates of couples that clearly will be less than twice the applicable exclusion amount, assuming the DSUE amount is not lost due to the last deceased spouse rule, there is no competing tax benefit and the basis step-up is a clear advantage.

      EXAMPLE: John and Janet each have estates of $3,000,000. If John dies and leaves his $3,000,000 in a credit shelter trust for Jane, the trust assets will not receive a step-up in basis at Jane's death. Assume the assets grow to $5,000,000 and there is $1,400,000 of unrealized gain. Instead, if John left the $3,000,000 directly to Janet, and his executor elected portability the assets would be included in Janet's estate. All unrealized gain on the assets would be eliminated at Jane's death, avoiding potential capital gains tax of over $330,000.

   b. In estates that are near or above twice the applicable exclusion amount, there may be a trade-off of income tax savings versus estate tax savings.

3. Use With Depreciating Assets. If the decedent's estate contains assets that likely will depreciate in value, such as promissory notes with imbedded

income in respect of a decedent ("IRD"), then passing those assets to the surviving spouse may be preferable to using them to fund a credit shelter trust. If most of the decedent's estate consists of these assets, then portability may be a good option.

4. Retirement Accounts.

   a. In many estates, a high proportion of the wealth is in retirement accounts. Because the assets are IRD, they will shrink by the income taxes incurred as distributed. In addition, the minimum distribution rules for retirement accounts are less favorable when the account is allocated to a trust. The account likely will need to be distributed more rapidly if allocated to a credit shelter trust.

   b. The preferred disposition for many married couples is to leave retirement assets to the surviving spouse. In the past, a typical beneficiary designation named the spouse as primary beneficiary and the participant's revocable trust as contingent beneficiary. The spouse then could disclaim a portion of the retirement assets if they were needed to fund the credit shelter trust and the spouse and his or her advisors decided that increasing the funding was worth foregoing the income advantages of rollover by the spouse.

   c. With portability, the surviving spouse can avoid the choice between maximizing estate tax benefits and maximizing income tax benefits.

      EXAMPLE: Assume the applicable exclusion is $6,290,000. John has a $6,000,000 estate, with $3,000,000 consisting of several rollover IRA accounts. John designates Janet as beneficiary of the IRA accounts. At his death, $3,000,000 passes to a credit shelter trust, and the remaining $3,000,000 of IRA accounts to Janet. John's executor elects portability for John's $3,290,000 of DSUE. Janet dies with a separate estate of $7,000,000, including $2,500,000 remaining in the IRAs (a decrease due to minimum distributions and income tax on those distributions). She has applicable exclusion of $9,580,000 consisting of her $6,290,000 and $3,290,000 of DSUE amount from John.

5. Residence.

   a. A residence, particularly the primary residence, is another asset that may represent a substantial portion of the couple's wealth but that is often a poor candidate for use to fund a credit shelter trust.

   b. For example, the client may want to continue to take deductions generated by the real estate taxes and the home mortgage on her personal income tax return.

c. If there is a mortgage, there may not be any cash in the trust with which to make the mortgage payments, and asking the beneficiary to pay those expenses may raise issues about whether the beneficiary has become a grantor of the trust by making principal payments on the mortgage.

d. If the house is owned in part by the credit shelter trust and in part by the surviving spouse, keeping track of each payment and the allocation of every expense will be bothersome and can be expensive.

e. If it is necessary to transfer the home to one spouse or the other to be sure that spouse has sufficient assets to fund a credit shelter trust and the "wrong" one dies first, there is not any adjustment in the basis of the residence if the surviving spouse would like to sell the property.

f. Ownership of the house in a trust might impact the availability of the homestead exemption or other tax benefits.

C. Advantages of Credit Shelter Trust Planning

1. Shelter of Appreciation and Income. The DSUE amount is not indexed for inflation. A credit shelter trust creates the opportunity for future appreciation and income to increase the value of assets outside the estate.

EXAMPLE: Wife dies in 2013 with assets of $4,000,000, all of which are left to Husband. As Wife's executor, Husband elects portability and receives $5,250,000 of DSUE amount. Husband had $3,000,000 of assets of his own, so after Wife's death he had a total of $7,000,000 of assets and $10,500,000 of applicable exclusion amount. Husband invested half the assets in a new business. Ten years later it is worth $20,000,000. His other assets have appreciated to $5,000,000 so his total estate is $25,000,000. Assume that Husband's basic exclusion amount is $12,400,000 in 2023. With the DSUE amount, which is not inflation adjusted, he can shelter $17,650,000 from estate tax.

If Wife had created a credit shelter trust with her $4,000,000 and Husband had used those funds for the business investment, all $20,000,000 would be sheltered from estate tax.

a. The additional shelter of a credit shelter trust is not likely to be a significant issue where the clients' net worth is modest. However, with younger couples it is hard to predict what their wealth will be many years in the future.

b. In addition, one should not completely ignore the possibility that Congress could lower the applicable exclusion in the future. It

would be unfortunate if a couple with an estate slightly under twice the exclusion amount decided to rely on portability and the survivor dies when the basic exclusion amount is back to $3,500,000.

2. Generation-Skipping Tax Planning. There is no portability of GST exemption. A couple who wants to maximize the amount of property held in long-term trusts for descendants will want to use credit shelter planning.

   a. Assuming the decedent's remaining applicable exclusion amount is being transferred to the surviving spouse through a portability election, the only way the decedent can take advantage of her remaining GST exemption is to use a reverse QTIP trust. IRC § 2642(a)(3).

   b. All of the income of the QTIP trust is required to be distributed, so the value of the assets in the trust may not increase as rapidly as in a trust that can accumulate income.

   c. In addition, if the reverse QTIP is the only QTIP created in the estate of the first spouse to die, or if the regular QTIP trust is not large or has been depleted, or, in worst case, if the regular QTIP trust is not obligated to pay the estate tax due on the reverse QTIP trust, the estate tax due at the death of the surviving spouse might have to be paid from the GST tax exempt assets in the trust. This will clearly reduce the effectiveness of the GST exemption allocation.

3. Impact of Remarriage. A risk with portability is that the surviving spouse will lose some or all of the DSUE amount if he or she remarries and the second spouse also predeceases him or her. In addition, DSUE amount is not cumulative. By contrast, the surviving spouse's remarriage does not impact the benefits of a credit shelter trust and the surviving spouse can accumulate multiple credit shelter trusts.

   EXAMPLE: John has survived Janet and is now a beneficiary with his children of a credit shelter trust holding $3,000,000. He also has $2,490,000 of DSUE amount from Janet. John marries Mary. Mary also predeceases John and leaves her entire $12,000,000 estate to a trust for her family. John's DSUE amount becomes -0-. The credit shelter trust is unaffected.

   EXAMPLE: Same facts as the preceding example except that Mary leaves $7,000,000 of her estate to a credit shelter trust for John and his children. John and his children are now beneficiaries of two credit shelter trusts funded initially with $10,000,000.

4. Protective Benefits of a Trust. A trust of course provides all the spendthrift protections that are at the core of estate planning. The trust assets are insulated from claims of creditors, are more protected if the surviving spouse remarries, and are better protected from misuse or misappropriation by the children.

   a. A decedent can achieve the same protective benefits by creating a marital trust for the surviving spouse, who still can claim DSUE amount.

   b. Because a QTIP trust is always an option in the planning, portability should not be viewed as directly incompatible with the use of trusts.

   c. A credit shelter trust can benefit both spouse and descendants, and does provide greater flexibility regarding use of the trust property.

5. Avoiding Potential Audit Issues.

   a. If the credit shelter trust is funded with non-publicly traded assets that are difficult to value, the family can avoid risk of audit with respect to those assets at the second death.

   b. The credit shelter trust also allows a family that owns a closely-held business to isolate voting control outside the estate, or divide a controlling interest so voting control does not end up in the hands of the surviving spouse.

      EXAMPLE: John owns a business that continues to do well and increase in value. Several years ago, John recapitalized the business and created classes of voting stock and nonvoting stock. He transferred 20% of the voting stock to an irrevocable trust and 40% to Janet. Janet dies. Her estate plan leaves her voting stock to a credit shelter trust, of which John is trustee. At John's death, John had the ability to vote 80% of the voting stock, but he owned only 40% of that stock directly. He is not considered to have voting control for estate tax purposes.

D. Considerations with Non-standard Families

1. Estate planners should be cautious about relying on portability for married couples where there are children from a prior marriage, or other non-standard family situations. The estate planning attorney needs to consider whether leaving an executor with discretion to use portability is even appropriate, and if it is, who the executor should be and how the estate tax burden should be allocated.

2. The problem with portability in non-standard families is that it allows the surviving spouse to use the DSUE amount personally, rather than for the beneficiaries of the first spouse to die. In effect, electing portability is like leaving assets outright to the spouse.

3. The regulations provide that, for a testate decedent, only the executor can make the portability election. Treas. Reg. § 20.2010-2(a)(6). In these mixed family situations, the executor probably should not be a beneficiary under the estate plan, and/or should be directed as to a portability election.

   a. For example, if the estate is not large enough to independently require the filing of an estate tax return, an executor who is a child of a prior marriage may choose not to incur the expense of filing an estate tax return solely to make the portability election for the second spouse.

   b. Rather than have the parties disagree over the need for a return, or over covering the cost of its preparation, it is better to have the estate plan direct whether an estate tax return should be filed to elect portability, and, if so, who is responsible for the cost of the preparation and filing.

4. Often, in a complex family structure where a client has children from a prior marriage, a QTIP trust is used for the surviving spouse, with the trust assets eventually passing to the client's descendants. However, when a QTIP trust is combined with portability, the client's estate plan may not operate as intended.

   EXAMPLE: John marries Margaret several years after his wife, Janet dies. John has three children from his marriage to Janet. John bequeaths most of his estate to a QTIP trust for Margaret, remainder to his children. He names Margaret as executor. Margaret elects QTIP treatment for the trust and portability. She then makes gifts of her own assets to her family using John's DSUE amount. Margaret dies with an estate equal to her basic exclusion amount, which she also leaves to her family. The QTIP trust pays estate tax, and John's children receive no benefit from his exclusion amount.

   a. Even if Margaret did not make gifts to her family, assuming that her estate was large enough to absorb most of her applicable exclusion amount (including the DSUE amount), the QTIP trust would have to contribute to cover the taxes attributed to it, unless the estate plan waives reimbursement.

   b. Code Section 2207A requires reimbursement on a marginal not proportionate basis. Thus, the QTIP trust could bear most or all of the estate tax at the second spouse's death, while the second

spouse's personal assets are sheltered in part by the deceased spouse's DSUE amount.

5. In cases such as these, the more prudent course of action may be to use traditional credit shelter/marital deduction planning. If there is DSUE amount available, then estate plan should direct whether it will be used and how the tax burden on the QTIP trust is handled.

6. These issues also could be addressed in a prenuptial or postnuptial agreement. For example, the parties could agree to permit the surviving spouse to have the use of any DSUE amount of the first spouse to die in return for an agreement that the surviving spouse would waive the right of reimbursement for tax due as a result of the inclusion of the QTIP trust in the surviving spouse's estate (or at least for that portion of the QTIP trust equal to the DSUE amount).

E. Impact of State Estate Tax

1. Most states that have a separate death tax or state estate tax tied to the old federal state death tax credit have not enacted portability for state tax purposes. Maryland and Hawaii appear to be the only exceptions.

2. A couple will forego use of the sheltering benefit of the state exclusion at the first death if they are relying entirely on portability. This could result in more state estate tax at the second death.

EXAMPLE: John and Janet are Illinois residents. Illinois has a $4,000,000 threshold for its state estate tax. John has $6,000,000 of assets and Janet has $3,000,000 of assets. They want their estate plan to be as simple as possible. Pursuant to their estate plan, all of John's assets pass to Janet at his death in 2017. His executor elects portability and passes John's $5,490,000 DSUE amount to Janet. At Janet's death, assume her estate is $9,000,000. It is sheltered from federal estate tax by her applicable exclusion amount (which includes the DSUE amount from John). However, Janet's estate is subject to Illinois estate tax of $801,049.

Assume John's estate plan instead creates a $4,000,000 credit shelter trust, and leaves $2,000,000 outright to Janet. Janet elects portability for the remaining $1,490,000 of John's exclusion. At Janet's subsequent death, her estate consists of the $2,000,000 from John and her separate $3,000,000. This is sheltered by her applicable exclusion amount and she owes no federal estate taxes. Her Illinois taxable estate is $5,000,000. The Illinois estate tax at her death is $285,714.

3. By contrast, portability may provide a benefit in some estates by allowing the couple to avoid estate tax at the first death while still preserving the decedent's full exclusion amount.

a. Before portability, a couple living in a state with a lower state estate tax threshold who are using a typical marital/nonmarital estate plan and who wanted to avoid all estate tax at the first death would use a formula that funds the credit shelter trust with the largest amount that can pass free of federal and estate state tax.

b. In Illinois, the estate plan could allocate $4 million to the nonmarital trust. In Massachusetts, only $1 million would be allocated to the nonmarital trust. The remaining assets, if any, would pass to a marital trust or the spouse.

c. In states with a state only QTIP election, a QTIP trust could be used to preserve the federal exclusion. In states that do not allow a state only QTIP, the couple had to either under-utilize the federal exclusion or pay state estate tax at the first death.

d. Couples now can rely on portability at least to the extent of amounts greater than the state estate tax threshold. They still may owe state estate tax at the survivor's death, but all other things being equal, it is best to defer payment. And, if the surviving spouse moves to North Carolina, Florida or one of the many other states with no state death tax, he or she will avoid state estate tax entirely.

4. The possibility of a change of residence is a factor to consider with all clients. Assume a couple is living in a state that does not impose a state estate tax and they rely on portability at the death of the first spouse to die. However, several years later, the surviving spouse moves nearer to grandchildren in a state that does impose an estate tax. The assets that could have been protected from state estate tax in a credit shelter trust established at the death of the first spouse to die will be subject to state estate tax at the death of the surviving spouse.

VI. Planning Options Under Current Law

A. What Produces the Best Overall Tax Result?

1. Several trust and estate practitioners and investment firms have conducted mathematical analyses of the benefits of a traditional marital/nonmarital estate plan versus relying completely on portability. The studies focus on the trade-off of estate tax savings versus lost step-up in basis.

a. The outcome of the comparison depends on the assumptions made regarding the size of the estates, the asset growth following the first death, how much of the gain is realized during the surviving spouse's life, and how long the surviving spouse lives.

b. Not surprisingly, in estates well under the spouses' combined exclusion amounts, portability is superior from a purely tax standpoint, because of the certainty of a full income tax basis step-up at the second death. However, the impact of state estate tax can change the result. In most cases, it is important to shelter the state exclusion amount from estate tax at the first death.

c. In estates that are close to twice the exclusion amount, portability may be better if the surviving spouse dies within five or six years of the first spouse. However, depending on assumptions about asset growth, if the surviving spouse lives for a longer period, the appreciation of the assets against a fixed DSUE amount creates a higher estate tax, and overall worse result, than there would be using a credit shelter trust.

d. In many of the scenarios, the benefit of one alternative over the other tends to be relatively small - about 3% to 5% of the value of the assets after 10 years.

2. The outcomes reinforce the conclusion one can draw from the preceding discussion. In light of the many variables that could impact the outcome, it is very difficult to predict at the time an estate plan is being drafted whether to rely on portability or use a traditional marital/nonmarital estate plan.

3. For clients where portability might be a superior option, the estate planner can choose a plan that defers the decision to use portability until after the first spouse's death. The estate planner will have much better information on all the factors that can impact a decision, including the surviving spouse's age and health, the children's needs, the current estate tax and income tax rates, the mix of assets and their growth potential, and whether the clients reside in a state with a state estate tax.

B. Flexibility Planning Options

In creating an estate plan that defers the decision on portability, there are three primary options to choose among:

1. <u>Disclaimer plan</u>. The estate plan leaves the assets of the first spouse to die outright or in a marital trust to the surviving spouse, but provides that if the surviving spouse disclaims, the assets will pass to a credit shelter trust. The credit shelter trust could be for the sole benefit of the surviving spouse or for spouse and descendants.

a. The danger with this option is that the surviving spouse fails to disclaim, even when it would be advantageous to do so.

b. The surviving spouse also could be disabled. An agent under a power of attorney, assuming he or she has the authority to disclaim on behalf of the spouse, may be reluctant to do so.

c. The attorney also needs to make sure the spouse does not take actions post-mortem that constitute acceptance of the decedent's property.

2. Single Fund QTIP. The plan leaves all the assets to a QTIP trust for the surviving spouse. The executor for the deceased spouse then can choose to elect the marital deduction for the trust and rely on portability, or not to make the QTIP election for all or a portion of the trust.

a. The trustee of the QTIP trust usually is given the power to sever the trust into elected and non-elected portions.

b. This plan puts the decision in the hands of the executor, who may be best suited to make the decision. It allows for the decision to be made up to 15 months after the date of death, rather than nine months with a disclaimer.

c. Some practitioners expressed concern that the QTIP option would not be available due to Rev. Proc. 2001-38, 2001-1 C.B. 1335, which allows a taxpayer to ask to treat a QTIP election as null and void if unnecessary to reduce estate tax. The service indicated informally that it will not use Rev. Proc. 2001-38 against taxpayers, and in Rev. Proc. 2016-49 I.R.B. 2016-42, confirmed that it will not disregard a QTIP election in an estate in which the executor made the portability election.

3. Clayton QTIP. This is not a different kind of QTIP trust, rather it is an add-on to traditional QTIP. In addition to the QTIP trust, the estate plan can contain provisions for a credit shelter trust. If there is a non-elected portion of the QTIP trust, the trustee can elect to allocate it to the credit shelter trust, thereby creating a trust for spouse and descendants. This option is based on Estate of Clayton v. Comm., 976 F.2d 1486 (5th Cir. 1992), where the court invalidated a Treasury Regulation that stated that a trust would not qualify for QTIP treatment if the allocation of property to it was contingent on making the election. Other cases followed, and the Treasury changed the regulation to conform to the court ruling. See Treas. Reg. § 20.2056(b)-7.

a. This option is superior to the disclaimer approach in that the surviving spouse can retain powers of appointment over the credit shelter trust. He or she cannot do that in a credit shelter trust funded by a disclaimer.

b. The decision to allocate the non-elected portion of the QTIP to another trust should not be made by the surviving spouse. If the spouse is executor or trustee, there should be provisions to allow an independent co-fiduciary to make the decision.

c. An estate plan that allocates the trust residue to a Clayton QTIP with a credit shelter trust option will look very much like a traditional A/B estate plan. As the clauses below reflect, the primary change is to the allocation language at the first death.

SAMPLE ALLOCATION AT DEATH PROVISION:

ARTICLE I

Allocation at Death

As of my death, but after providing for the payment of any debts, taxes, and administration and other expenses, as provided later in this instrument, the trustee shall administer the balance of the trust principal (including property to which the trustee may be entitled from any other source, and subject to any specific allocation applicable to such property pursuant to the exercise of a power of appointment or otherwise) as follows:

A. First, the trustee shall distribute any tangible personal property that is then held hereunder pursuant to the terms of my will then in effect (and any memorandum separate from my will that I may leave), such terms being incorporated herein by reference. If no will of mine is admitted to probate in any jurisdiction within three months after my death, the trustee may rely upon any instrument the trustee reasonably believes to be my last will or such memorandum for purposes of making this distribution.

B. Finally, the trustee shall administer the balance of that trust principal as follows:

1. If my spouse survives me, the trustee shall allocate the trust principal to the Marital Trust, to be administered in the manner provided in subsequent Articles of this instrument; provided, however, that the trustee shall allocate to the Family Trust that portion of the trust principal which is (i) effectively disclaimed by my spouse, or (ii) allocated pursuant to subparagraph 2 of paragraph A of the Marital Trust Administration provisions of this instrument with respect to principal for which no qualified terminable interest property election is made; or

2. If my spouse does not survive me, the trustee shall allocate the entire trust principal to the Family Trust, to be administered in the manner provided in a subsequent Article of this instrument.

SAMPLE MARITAL TRUST ADMINISTRATIVE PROVISION:

ARTICLE II

Marital Trust Administrative Provisions

A. My executor (as that term is used in Section 2056(b)(7) of the Code) may elect to have a specific portion or all of the Marital Trust (referred to as a "marital portion") treated as qualified terminable interest property for federal or state estate tax purposes. If one or more portions of the Marital Trust are subject to different elections, each portion shall be expressed as a fraction, and the value of each portion at any time may be determined by multiplying the value of the Marital Trust at that time by the fraction then in effect for that portion. The trustee may charge a discretionary distribution all to one portion, or to more than one portion, by adjusting each fraction, first by restating it so that the numerator is the value of each portion and the denominator is the value of the marital portion and of the Marital Trust, in each case immediately before the distribution, and then by subtracting the amount of each distribution charged to a portion from the numerator of the fraction for that portion and subtracting the total of all distributions from each denominator, except that the numerator shall not be reduced below zero. Alternatively, as of the date of my death, the trustee may:

1. Divide the Marital Trust into separate trusts, representing the fractional portions for which different elections apply, and administer them as separate trusts hereunder (but subject to a common set of provisions); or

2. Allocate the fractional portion for which no qualified terminable interest property election was made to the Family Trust, to be administered as a part thereof; provided, however, that neither my spouse nor a primary remainder beneficiary of the Marital Trust, if acting as a trustee thereof, shall exercise this power.

B. The allocation to the Marital Trust if my spouse survives me and the provisions of paragraph A of this Article are intended to give the personal representative of my estate the option to shelter property from estate tax at my death using the federal applicable exclusion or a state estate tax exclusion, or to rely on the election under Code Section 2010(c) and use of the deceased spousal unused exclusion amount. I request that the personal representative of my estate consider these options fully, and the trustee consider allocating any non-elected portion of the Marital Trust to the Family Trust.

C. The following case study examples assume applicability of the pre-2017 Tax Act exclusion. During the period of 2018-2025 the same principles can be applied to estates twice the size indicated, but only if you assume the couple dies during that period.

D. Case Study of Estate Under $5,500,000

EXAMPLE: John and Janet Jones are married with two children. They have a net worth of $5,000,000, consisting of a jointly owned house ($500,000), joint bank and investment accounts ($2,350,000), 401k/retirement accounts (John $600,000, Janet $250,000), two life insurance policies (each $600,000) and $100,000 of personal belongings and miscellaneous minor investments.

1. Portability was designed for couples like John and Janet in this example. They are safely under twice the applicable exclusion amount and a significant portion of their wealth is in their home and retirement accounts, neither of which are good assets for a credit are shelter trust.

2. The primary additional facts the estate planner would want to know before recommending a plan designed to use portability are the couples' ages and compensation. If John and Janet are both in their young 30's and in jobs with significant upside in their compensation, they may eventually accumulate a net worth greater than twice the exclusion amount. However, a portability plan still is probably adequate for now. If John and Janet are in their 70's and retired, the estate planner can be relatively confident that their estates will not grow significantly.

3. John and Janet will need advice on whether to use a trust for the survivor. If they are concerned about creditor protection because of their professions, or if they want to ensure that some property is protected for children in case the surviving spouse remarries, they will need to divide some of their joint assets for reasons other than tax planning, in order to fund a trust at the first death.

4. In addition, if John and Janet live in a state with a state estate tax and no portability, they may want to plan to set aside at least the state exclusion amount in a credit shelter trust at the first death, to reduce state estate tax.

5. If John and Janet want to use a trust for the survivor, or need a trust to shelter property from state estate tax, then it is likely that their planning will require some retitling of assets to make sure property does not pass directly to the survivor at the first death.

E. Case Study of Estate in the $5,500,000 to $11,000,000 Range

EXAMPLE: Assume John and Janet Jones have a net worth of $8,000,000, consisting of a jointly owned primary residence ($500,000), a condominium in Colorado in Janet's name ($300,000), joint bank and investment accounts ($2,000,000), a private venture capital investment in John's name ($1,200,000), a separate investment account in Janet's name, inherited from her parents ($2,000,000), John's retirement account ($1,000,000) and life insurance on John's life ($1,000,000).

1. The actual upper end of the range of estates in this category is twice the exclusion amount. That figure was $10,980,000 in 2017. If both John and Janet are living in 2026, it should be $13,000,000 to $16,000,000.

2. Many couples with estates in this range also can rely on portability to avoid or minimize federal estate tax. The same factors that are relevant for smaller estates are relevant here also. There should be a bit more focus on potential growth in the value of the estate, and whether there are assets that would benefit from the complete estate tax shelter of a credit shelter trust at the first death, rather than the more limited shelter of a fixed DSUE amount.

3. Even if there are reasons to use a credit shelter trust, portability relieves couples like John and Janet of the burden of having to make significant changes in the titling of their assets.

   a. If there was no portability, the estate planner might suggest that John and Janet split their joint investment account into separate $1,000,000 accounts.

   b. Even then, the most John could get into a credit shelter trust at his death would be $4,200,000 and that would include the retirement account, which is not a desirable asset for the credit shelter trust.

4. In this respect, portability does greatly simplify the planning.

   EXAMPLE: John and Janet decide to use traditional credit shelter planning. However, they do not want to divide their joint accounts. Janet does want her inherited investment account to go into a trust for John and her children. She feels it would be her parents wish that the account go to her children, but the trust allows her to give John income if he needs it. Janet dies first, in 2017. Her plan sets aside the $2,000,000 account in a trust and the other assets pass to John. Portability is elected for $3,490,000 of DSUE amount. John has an estate of $6,000,000 and applicable exclusion that includes $3.49 million of DSUE amount. Assume John's estate grows to $9,000,000 by the time of his death in 2023, and that legislation has eliminated the change of the 2017 tax act. His basic exclusion is now $6,700,000, and his total exclusion amount is $10,190,000. No federal estate tax is due and all the assets except those in the trust created at Janet's death receive a step-up in basis.

5. The wild card for estates near twice the exclusion amount will be the amount of appreciation in the future. If John and Janet are younger, and John's venture capital investment is the first of what he expects to be many as a young partner in a venture capital business, their estates could grow rapidly.

EXAMPLE: John and Janet rely on portability. Five years later, John's venture capital investment pays out $6,000,000 in the form of stock of an acquiring company. He has made several other investments through his firm, now worth $5,000,000. Some of these are in early stages and have significant appreciation potential. Other assets also have appreciated. John and Janet's net worth is now $18,000,000.

6. At this point, hopefully John and Janet have visited their estate planning attorney to have their estate plan reviewed. If they were relying on portability in their initial plan, they can reconsider the decision now.

7. Estates that are under the estate tax threshold but could be reasonably expected to grow will eventually reach a cross-over point, where the estate tax savings of sheltering assets fully in a credit shelter trust (versus relying on a fixed DSUE amount) will exceed the income tax benefits of a second step-up in basis at the survivor's death. This assumes no further planning by the surviving spouse in conjunction with using portability as discussed below.

   EXAMPLE: John and Janet rely on portability. John dies unexpectedly in 2013 shortly after the plan is completed. After electing portability, Janet has an estate of $8,000,000 and has $10,590,000 of applicable exclusion. Assume the venture capital investment pays out $6,000,000 after John's death, in the form of stock of an acquiring public company. Janet also received another family inheritance of $5,000,000. Her estate is now $17,800,000, and assume the total applicable exclusion amount, with inflation adjustment for the basic exclusion, is $11,050,000.

   If John had instead created a credit shelter trust with the venture capital investment and his life insurance, the trust would receive the $6,000,000 stock payout, and have $7,000,000 total. Janet would have $10,800,000 ($5,800,000 after John's death plus the $5,000,000 inheritance) and total available applicable exclusion of $8,850,000 (her basic exclusion, assume $5,800,000 million, and $3,050,000 of DSUE amount). The net assets available for the children if Janet now dies are greater with a credit shelter plan.

	Portability	Partial Credit Shelter
1. Janet's estate	$17,800,000	$10,800,000
2. Exclusion amount	(11,050,000)	(8,850,000)
3. Taxable Amount	6,750,000	1,950,000
4. Estate tax (40%)	2,700,000	780,000
5. Credit Shelter Trust	-0-	7,000,000
6. Capital gain in Trust (23.8%)	-0-	(1,142,400)
7. Net Credit Shelter Trust		5,857,600
Total to Children (1 - 4 + 7)	$15,100,000	$15,877,600

8. However, the preceding example does indicate that the loss of a basis step-up can have a significant cost in some situations. With the higher capital gains tax rates now in effect (58.6% higher than prior to 2013), the clear benefit of avoiding estate tax in favor of possible capital gain tax has eroded.

   EXAMPLE: Same facts as the preceding example, except that Janet does not receive an additional inheritance. At her death, Janet has an estate of $12,800,000 and an applicable exclusion amount of $11,050,000. The estate tax in her estate is $700,000. However, because the $6,000,000 in stock receives a step-up in basis, Janet's heirs have avoided $1,142,400 of capital gains tax.

9. If the foregoing examples do not already sufficiently illustrate the unpredictability of the tax benefits of portability, consider that John's venture capital investment may not pay out in kind. If the payout is in cash, the capital gain will be incurred during Janet's life regardless of whether Janet or a credit shelter trust owns the investment.

10. The final variable, present in every case, is the last deceased spouse rule. If Janet remarries and her new husband predeceases her, Janet's DSUE amount could increase, decrease, or disappear entirely.

    a. If, in the last example, John's estate plan relied on portability, and Janet loses all her DSUE amount when her second husband predeceases her, she would have only her $5,800,000 inflation adjusted basic exclusion amount. Her $17,800,000 estate would incur estate tax of $4,800,000.

    b. The estate planning response to avoid this result would be to encourage Janet to make a gift of some or all of John's DSUE amount. As described previously, this allows the surviving spouse to lock-in use of the DSUE amount. Once DSUE amount has been used to shelter a gift, the spouse cannot lose it later under the last deceased spouse rule.

c. A gift to a trust for descendants largely would replicate the benefits of credit shelter trust. It could have the added benefit of being structured as a grantor trust, so the surviving spouse remains responsible for taxes on trust income.

d. The major drawback is that the surviving spouse would not be a beneficiary of the trust. Janet could conclude that her estate is not large enough for her to give up $5,250,000 of property shortly after John's death (about 30% of her net worth). However, she may be comfortable making a gift of $2,000,000 or $3,000,000.

e. The ultimate outcome depends on a myriad of facts and circumstances. How emotionally secure is Janet? How willing is she to benefit her descendants during life? Is Janet still paying attention to her estate planning? Has the couple's attorney retired? Is her successor paying attention to Janet's estate?

F. Estates of $11,000,000 to $22,000,000

EXAMPLE: Assume John and Janet Jones have a net worth of $18,000,000. They own two residences, total value $3,000,000, retirement accounts of $1,000,000 marketable securities and cash accounts of $6,000,000 and Janet's $8,000,000 of stock in a C corporation owned by her family.

1. All the same factors and variables present for the couple in the $5,500,000 to $11,000,000 range are present here also, with a few additional factors to consider.

2. For couples in this range, much depends on Congress and what changes are made to the estate tax exclusion amounts.

   a. If Congress makes the changes of the 2017 tax act permanent, couples in this range are the new version of couples in the $5.5 million to $11 million range.

   b. If the provisions of the 2017 tax act expire, or Congress cancels them before 2026, there is a high degree of certainty that a couple with an $18,000,000 estate will pay estate taxes. Unless they are very high spenders, or very poor investors, their combined estate likely will stay above their combined applicable exclusion amounts, even with inflation adjustments.

3. For a clearly taxable estate, the mathematical trade-off of a credit shelter trust that will shelter future growth from estate tax versus electing portability and receiving a second step-up in basis at the survivor's death more clearly favors the credit shelter trust. At a simplistic level, every dollar of unrealized appreciation that could be sheltered in a credit shelter trust will avoid estate tax at 40%, but incur capital gains tax at 23.8%.

a. State taxes may close the gap, especially for California residents. But, at least under current tax rates, estate tax avoidance appears to be more beneficial.

b. This is true even for John and Janet if Janet dies first and allocates stock in the family corporation to the credit shelter trust. It is more likely with the family stock that all the appreciation will be unrealized gain. However, if the corporation is a S corporation and not distributing all its income, its basis may increase over time during John's life. If the credit shelter trust holds marketable securities, there likely will be gain incurred annually due to turnover in the portfolio.

4. On the other hand, in this range of wealth, John and Janet are better able to make lifetime gifts. They would be a candidate for using portability at the first death with the survivor making a gift using the DSUE amount shortly after the first spouse dies.

G. Estates Over $22,000,000

EXAMPLE: John and Janet Jones have a net worth of $30,000,000. Their assets include an investment portfolio of $15 million and interests in a family investment LLC worth $5 million and a family partnership holding timberland worth $3 million. John and the couple's descendants also are the beneficiaries of several trusts created by John's parents and grandparents, which hold much larger interests in the family LLC and family partnership. John currently receives income from these trusts and can give Janet an income interest if she survives him.

1. Portability was not enacted for couples of this level of wealth. In this example, John and Janet understand trusts, are used to complexity in their assets, and probably are in regular contact with estate planning professionals. It would not be an undue burden for them to title assets in a manner that would facilitate optimum marital planning, and full use of the available applicable exclusion amount at the death of the first to die in a credit shelter trust. They probably already have used some of their exclusion for lifetime gifts.

2. In fact, John and Janet easily can afford to make large lifetime taxable gifts. If they have not already done so while both are living, then a plan that relies on portability combined with the surviving spouse making a large taxable gift to a grantor trust using the DSUE amount could deliver superior results.

EXAMPLE: John's estate plan leaves all his assets to Janet. He dies in 2017. John's executor files an estate tax return and elects portability. Janet immediately makes a gift of $5,490,000 to an irrevocable trust for

their descendants, and uses John's DSUE amount to shelter the gift. The trust is structured as a grantor trust. Janet's payment of the income tax on trust income will allow the trust to accumulate more for their descendants.

a. By using John's DSUE amount immediately in connection with a gift, Janet eliminates the risk of losing the DSUE amount if she remarries and her second husband predeceases her.

b. The most significant potential drawback of this plan is that Janet has given up use of the assets transferred by gift. She could have been a beneficiary of a credit shelter trust created by John. However, this should not be an issue for a couple of John and Janet's wealth.

c. John and Janet also will not utilize GST exemptions to the ideal extent. John still could use his GST exemption with other assets by leaving them in a QTIP trust for Janet. A reverse QTIP election could be made for the trust. Janet must receive income from this trust, but it can be invested to minimize the production of income. Janet's plan should waive any right to reimbursement for estate taxes from the reverse QTIP trust.

3. The plan just described can provide additional benefits for clients in states with a state estate tax and a tax threshold below the federal exclusion amount.

a. If John and Janet live in Illinois, for example, estate tax will be incurred at the first death if the credit shelter trust exceeds $4,000,000.

b. With the use of portability, the state estate tax is avoided at the first death. Janet's gift of the DSUE amount is not subject to state transfer tax provided John and Janet do not live in Connecticut or Minnesota, the only states that impose a gift tax.

4. If the couple chooses a more traditional plan, and they live in Illinois, the estate plan would create a $4 million credit shelter trust at the first death, and a state-only QTIP trust to soak up the remaining federal applicable exclusion available. The executor of the first spouse to die could elect QTIP for that trust for federal purposes too, and pass some DSUE amount to the surviving spouse.

5. When considering this plan for wealthy clients, estate planners need to take into account the possibility of incompetence. In fact, we may find in the future that a high percentage of clients suffer from dementia, Alzheimer's or other mental disability before their physical health fails.

a. Financial powers of attorney and revocable trusts should include not only the power to make gifts but should also authorize the making of large gifts, fully using the exclusion amount, gifts that incur gift tax and gifts to trusts.

b. Even with these express powers, the agent or fiduciary for a surviving spouse nevertheless may be hesitant to fully implement such a plan for fear of criticism that she did not adequately preserve assets to meet the needs of the spouse.

6. Many clients at the wealth level of John and Janet already will have used most of their applicable exclusion amounts for lifetime gifts. In fact, many did use what was available in 2012. Ultra high net worth couples will do this again before 2026, if it appears that the extra 2017 tax act exclusion will disappear. For couples that do this, planning using portability will become moot for quite some time.

EXAMPLE: John and Janet have assets of $60 million in 2025. They fully used then available exclusion amounts in 2012, and have made some gifts using applicable exclusion since then. The full exclusion per person in 2025 is $12,640,000, and John and Janet each have 5,750,000 remaining in 2025. They make $11,500,000 of gifts in 2025 to use their remaining exclusions. In 2026, the exclusion reverts to $6,480,000, with the inflation adjustments. Neither John nor Janet will have any additional applicable exclusion until annual inflation adjustments cause the exclusion to exceed $12,640,000. At a 3% inflation rate that will take 23 years.

VII. <u>Conclusions on Portability</u>

A. Clear Recommendations

1. Portability will be most attractive in estates where the assets could exceed one applicable exclusion amount but are unlikely to exceed twice the applicable exclusion amount. A couple in this demographic may wish to leave all the assets of the first spouse to die to the survivor, and rely on portability to avoid estate tax.

2. The more important factor influencing a movement to simpler plans is the size of the applicable exclusion amount. With an exclusion of $5 million adjusted for inflation, just one exclusion amount will shelter the vast majority of estates even if there is no credit shelter planning. Couples can rely on portability to cover unanticipated increases in the value of the estate after the first spouse's death.

3. Clearly, the portability election should be recommended for estates where the couple is above or near the threshold for incurring tax and the first

spouse leaves unused exclusion. Portability provides an excellent back-up to planned use of the applicable exclusion amount. In the frequent situations where a couple fails to fully implement asset retitling, or the size or nature of the assets prevents full use of the applicable exclusion amount at the first death, an election to use portability can save applicable exclusion that otherwise would be lost.

4. If one spouse dies with the higher estate tax exclusion from the 2017 tax act in effect, and has unused exclusion for which portability is elected, that DSUE amount will not go down in 2026. Treas. Reg. § 20.2010-1(b)(4).

B. Flexibility

1. Beyond these few certainties, there lies the vast realm of uncertainty, a natural result of the unique nature of every client's assets and family circumstances.

2. Attorneys should view portability as another tool available in the planning process, not necessarily a superior tool. It will be in many cases but it is wrong to reach broad general conclusions.

3. In marital planning, then, as in most estate planning, the best approach is to maintain flexibility. Use both traditional credit shelter planning and portability, considering each alternative for each client situation, and deferring the decision where appropriate until the first death.

VIII. Other Changes in Planning Due to the Increased Exclusion

A. Careful Lifetime Gift Planning

1. The spread between estate tax rates and capital gains tax rates has dropped significantly. This clearly had changed the analysis in lifetime gift planning.

EXAMPLE: Jason makes a gift of a $500,000 asset. His basis in the asset is $300,000. The asset appreciates to $800,000 by the time Jason dies in 2000. The $300,000 of appreciation escapes estate tax, saving $165,000 (55% of $300,000). However Jason's family receives the asset without a step-up in basis. The cost of the lost step-up is $100,000 (20% of $500,000 of unrealized gain).

EXAMPLE: Jason makes the same gift of the same asset and it is valued at $800,000 when he dies in 2013. The estate tax savings is $120,000 (40% of $300,000). The cost of the lost step-up in basis is $119,000 (23.8% of $500,000 of unrealized gain).

a. In the second example, ignoring issues of timing and opportunities to avoid the capital gain, the transaction is essentially a wash. When state taxes are considered, Jason's family could be worse off because of the gift. In California, for example, the combined estate tax rate is 40% but the combined capital gains tax rate for a taxpayer in the highest bracket is 37.1%. The cost of the lost step-up in basis for a California family is $185,500.

b. The differential between estate tax rates and income tax rates is less than 10% in 5 states, and between 10% and 15% in another 20 states. See Lee, Paul S., "Paradigm Shift: The ATRA-Math," presentation by Bernstein Global Wealth Management (2013).

2. For estate tax purposes, every asset will receive at least one basis step-up. Thus, the impact of capital gains tax is different than the impact in gift planning. Unrealized gain and sheltered appreciation are being measured over the same period, the time between the first death and the surviving spouse's death.

a. Since capital gains tax rates (23.8% top rate federal) still are not as high as estate tax rates (40%), some argue that estate tax reduction is still most important.

b. Of course, if the estates of the couple are less than twice the exclusion amount, and who do not live in a state with a death tax, the only tax to plan for is income tax.

c. Moreover, in some states, the gap is much narrower when state taxes are taken into account. In New York, the effective estate tax rate is 49.6% and the top LTCG rate is 36.5% In California, the estate tax rate is 40% and the top LTCG rate is 37.1%

3. The life expectancy of the surviving spouse will be a factor in the analysis of estate tax versus capital gains tax. Looking at the different mortality tables used by the IRS under Section 7520 and Treas. Reg. Section 1.401(a)(9), the life expectancy of the surviving spouse after the first spouse's death is 14.2 to 17 years at age 70, 8.4 to 10.2 years at age 80, and 4.4 to 5.5 years at age 90.

4. The nature and mix of the couple's assets also are a factor.

a. Marketable securities may appreciate significantly after the first spouse's death, but if it is a managed portfolio, it is likely that some gain will be realized on a regular basis as part of the investment strategy.

b. A concentrated stock position in one public stock is less likely to have regular turnover if the family has a close connection to the company. However, if it was the decedent who has insisted on retaining the stock, and a professional trustee is now involved, it is likely that the position will not be maintained.

c. Commercial real estate, oil and gas interests, or timber interests actually may have a declining basis and may be subject in part to higher capital gains rates. Likewise, appreciated tangible personal property, such as artwork or collectibles, is subject to a higher capital gains tax rate (28%). Intellectual property rights such as copyrights or patents are usually subject to ordinary income tax rates during the life of the inventor.

d. In larger estates, the special tax attributes of specific assets traditionally are dealt with during post-death funding. The trustee would allocate securities or other assets to the credit shelter trust, and assets that are potentially taxed at higher rates or which will have a lower basis to the marital bequest.

5. Throughout the analysis, it is important to keep paramount certain general estate planning principles.

a. The estate plan must be a plan that will work well if death occurs the day after it was signed, but also must have sufficient flexibility to continue to function even as circumstances change.

b. The client will be less inclined toward lifetime transfers of property than the estate planning attorney. Many clients will not part with control of, or access to, assets even when it makes complete sense to do so from a tax standpoint.

B. Basis-Step Up Planning in Administering Trusts

1. The increased applicable exclusion and GST exemption will lead to other new, and seemingly radical, thinking.

2. The higher exclusion increases the number of situations where a family member who is a beneficiary of a trust will have a taxable estate significantly less than the annual exclusion.

3. If the trust has appreciated assets, it may be desirable to distribute those assets to the spouse or other family member who is primary beneficiary of the trust, in order to obtain a basis step-up for the asset at the beneficiary's death.

4. This of course raises a host of fiduciary issues. The trustee must be confident that any asset distributed to a beneficiary will pass according to the same plan as is embodied in the original trust. If the beneficiary has a power of appointment over the trust anyway, it will be easier to get comfortable with a distribution.

5. The planning will be most comfortable with surviving spouses where the couple has parallel estate plans. If it is late in the surviving spouse's life and he or she has not remarried, the disposition under a credit shelter trust most likely will be identical to the disposition under the surviving spouse's plan.

6. Distribution of the asset is not the only way to cause its inclusion in a beneficiary's estate. A number of papers and articles contain detailed discussions of the alternatives available for enabling the taxation of appreciated credit shelter trust assets in the estate of a surviving spouse. See, e.g., Zaritsky, "Portability: Getting Ready for Game Time," ACTEC 2011 Summer Meeting, at 10-21. Zaritsky suggests four options:

    a. Power in an independent trustee to make discretionary distributions from the credit shelter trusts to the spouse for the purpose of reducing income taxes.

    b. Discretionary power in a disinterested fiduciary to grant the spouse a general power of appointment over certain trust assets.

    c. An automatic grant of a general power of appointment by means of a formula.

    d. A grant of a non-general power of appointment in the surviving spouse trust that the spouse can exercise in a way to trigger Code Section 2041(a)(3) (the "Delaware tax trap").

    e. As Zaritsky discusses in detail, all the options present certain challenges and disadvantages. Not the least of the disadvantages is that a power granted to save income taxes ends up being used by a trustee or surviving spouse in a way to divert assets away from the decedent's intended beneficiaries.

7. The use of a general power of appointment that can be turned on or off can be fine-tuned by using a trust severance power. The trustee can segregate the assets for which a step-up is desirable in a separate severed trust, and the general power can be granted only over that trust.

C. Eliminating Trusts

1. Some clients whose estates now will be entirely sheltered from estate tax may ask about terminating existing irrevocable trusts they have created. While this may seem sensible from a narrow tax perspective, the client needs to consider other factors.

   a. Property that has been set aside in an irrevocable trust for a period of time is probably protected from creditors, of both the grantor and the beneficiaries.

   b. If the grantor already used exclusion or GST exemption to transfer the asset, the client should not waste those exclusions. If Congress later reduces the exclusion, or the asset begins to appreciate significantly, the client will regret having given up the shelter he or she had.

2. A client may be particularly tempted to terminate an irrevocable insurance trust. He or she may find the annual Crummey notice requirements to be inconvenient, and may question the need for the insurance at all.

3. If the decision is made to drop the insurance, then it admittedly may make sense to terminate the trust. This is particularly true if the cash value was low, and continuing to administer the trust is uneconomical.

4. If the policy is being kept, then consider the option of no longer sending Crummey notices. The premium payments would use lifetime exclusion, but for many clients the amount would be significantly less than the annual inflation increase. The client would need to file gift tax returns each year. If the current funding of the trust does not require gift-splitting, the client may not be filing returns currently.

D. Modifying Formula Allocations

1. A client who has not updated his or her estate plan in 10 or more years may have marital formula or GST formula provisions that no longer make sense.

2. In a standard A/B estate plan, for a client with an estate of $3-5 million, the failure to convert to a single fund QTIP or other portability based plan is not the end of the world. The formula will allocate all the property to the credit shelter trust, and some opportunity for a basis step-up at the second death may be lost. But the trust is still for the primary benefit of the spouse and his or her needs will be taken care of.

3. Some clients' plans left all of the credit shelter amount directly to the children, or to a trust in which the surviving spouse's rights were very limited. This may have made sense when the exclusion was $600,000 or

$1,000,000 and constituted a quarter or less of the decedent's estate. With the current exclusion, the plan may leave the spouse with inadequate means of support.

4. Likewise, a common plan for many clients was to provide that all assets that can be sheltered from GST tax at the surviving spouse's death will be retained in trusts for the children and their families, while all other assets will be distributed to the children.

    a. There are numerous variations on the plan. The non-GST share may be distributed outright to the children, or it may be held in trusts over which each child has withdrawal rights at designated ages. The non-GST share may remain in longer-term trusts, but each child designated as trustee and given substantial discretionary authority.

    b. The GST exempt portion may be held in a one-pot dynasty trust or allocated among separate trusts, one for each child and his or her descendants. Some clients by-pass the children entirely and direct that the GST exempt property be allocated among trusts for grandchildren.

5. With the increase in the GST exemption to $5,000,000, then $11,180,000, indexed for inflation, formula allocations that are based on the maximum amount of GST exempt property available in many cases will no longer carry out the clients' expectations.

6. To address the shift in favor of GST exempt property, many clients will want to define the second death allocations by referring to the lesser of a designated percentage and the amount of GST exempt property rather than solely by reference to GST exempt and non-exempt property. For example, an allocation could cap the GST exempt trusts at 70%, with non-exempt trusts receiving the remaining property.

7. If the clients do not want to change the allocation language in response to the increasing GST exemption, it is advisable to obtain written confirmation of that fact. The parents may be comfortable with the allocation of all of their wealth to long-term trusts, but the children may not believe it.

IX. Lifetime Giving

A. The general advantages of lifetime gifts are enhanced by higher exclusion. Wealthy individuals can set aside far greater amounts outside their estates. The impact of compounding on the higher gift amounts is significant.

EXAMPLE: A husband and wife in 2008 could give $2,000,000 to an irrevocable trust for the benefit of their descendants and not pay any gift tax. If the trust assets grew on average at a 5% after tax rate for 25 years, there would be over $6,770,000 in the trust at the end of that time period.

In 2013, a husband and wife could transfer $10,500,000 to the irrevocable trust without paying gift tax. If the trust assets grow at a 5% after tax rate for 25 years, there would be over $34.7 million in the trust. That amount may be large enough that the couple would want to leave most or all of their remaining estate to charity.

For those few couples who can afford to fully use the current $23,600,000 of exclusion, the compounded growth numbers are almost mind-boggling.

B. One presenter at the 2014 Heckerling Institute on Estate Planning suggested that the higher applicable exclusion should almost never be used for lifetime gifts. Instead, taxpayers should preserve it to maximize the basis step-up that will be non-taxable for estate tax purposes and instead should use gift techniques that use no or small amounts of exclusion, such as zero-out GRATs or sales to irrevocable grantor trusts. See Lee, "Venn Diagrams" at 2-12.

1. This suggestion is grounded in the concept that, in a unified tax system, a lifetime taxable gift only works to remove appreciation and post-gift income from the estate. A zero-out GRAT or sale does the same thing, after clearing a low rate of return hurdle given today's low AFR and Section 7520 rate.

2. The analysis would change if rates rise significantly.

3. It also does not take into account a number of situations that may make a direct gift using exclusion attractive.

a. The asset transferred is hard-to-value, making administration of a GRAT, and sometimes a sale, difficult and expensive.

b. The asset has no anticipated cash flow, and the goal is to not have any of the asset return to the grantor.

c. The client wants simplicity.

C. Many couples with estates in the $10 to $25 million cannot afford to make taxable gifts using their full exclusions (or believe they cannot afford to). They may be willing to take partial advantage of the higher exclusions this year, if they still have access to the property.

1. For example, H could make a $5 million gift to an irrevocable trust for W and descendants. W's beneficial interest in the trust gives her a safety net, and H shares in that safety net for as long as W is alive and they stay married.

2. H may be unwilling to make so large a gift, because of the possibility of divorce or W's premature death. Instead, H and W would prefer to each make a $2.5 million gift in trust, with the non-grantor spouse and descendants as beneficiaries.

D. Reciprocal Trusts. If two parties create identical trusts for each other, the IRS will recharacterize the trusts and treat them as if each party created a trust for himself or herself. At the death of one of the grantors, the trust created by the deceased grantor's spouse will be recharacterized as a self-settled trust and included in his or her estate under Section 2036. This is known as the reciprocal trust doctrine.

1. The two-prong test for determining if reciprocal trusts were established was set forth in United States v. Grace, 395 U.S. 316 (1969). Under Grace, the doctrine applies when the following two conditions are met: (1) the trusts are "interrelated," and (2) the arrangement, to the extent of mutual value, leaves the grantors in the same economic position as they would have been in had they created the trusts for themselves.

   a. In Grace, a husband and wife created irrevocable trusts two weeks apart. The trusts contained nearly identical terms. Each spouse's trust named the other spouse as income beneficiary. At the husband's death, the IRS asserted that his wife's trust should be included in his estate.

   b. The Supreme Court agreed with the IRS that the trusts were interrelated. The Court's analysis was brief. It noted that the trusts had substantially identical terms and were created at the same time. This appeared to be enough for the Court in the case before it. But it left much uncertainty about what minimum facts had to exist for trusts to be considered interrelated.

2. There have been several subsequent cases interpreting and applying the doctrine, some interpreting the tests quite narrowly, and some very broadly.

   a. In Estate of Levy v. Commissioner, 46 T.C.M. 910 (1983), husband and wife had created trusts on the same day and funded them with an identical number of shares of stock of the same corporation. Each was a life beneficiary and trustee of the other's trust. Both trusts named the couple's son as the remainder beneficiary. The Tax Court concluded that the trusts were not

interrelated because husband's trust granted wife an inter vivos limited power of appointment, and wife's trust did not contain a comparable provision.

b. The Tax Court in Estate of Bischoff v. Commissioner, 62 T.C. 32 (1977), applied the reciprocal trust doctrine to trusts in which neither spouse had any economic interest as a beneficiary. Husband and wife had created identical irrevocable trusts for their grandchildren. Each named the other as trustee. The court treated the trusts as if each spouse had named himself or herself as trustee and therefore had retained a § 2036(a)(2) right to designate the persons who would enjoy or possess the trust property.

c. This broader application of the doctrine was rejected by the Sixth Circuit in Estate of Green v. United States, 68 F.3d 151 (6th Cir. 1995). In Green, the husband created a trust for one granddaughter, with the wife as trustee, and the wife created an identical trust for another granddaughter, naming husband as trustee. The court ruled that the couple's powers as trustees did not constitute a retained economic benefit, so the reciprocal trust analysis did not apply.

d. The latest reflection of the IRS' point of view can be found in Letter Ruling 200426008. Husband and wife each created an irrevocable insurance trust, and named the other as trustee. The trusts contained significantly similar language but differed in several important respects. The husband's trust gave the wife several additional powers, including lifetime and testamentary powers of appointment. In addition, in the wife's trust, the husband did not become a beneficiary unless he was living three years after the wife's death, and he had a right to distributions only if his net worth or income fell below certain levels. The IRS decided that these differences were sufficient to prevent the trusts from being interrelated.

3. Because the tests are subjective in nature, there is no clear line demarking when husband and wife each can create irrevocable trusts for the other without invoking the doctrine.

a. The standard guidance is that husband and wife should not create the trusts at the same time, as part of one plan, with identical provisions for each other.

b. To be in the best position to avoid application of the doctrine, one of the trusts should not benefit the other spouse at all.

c. Beyond these two guideposts, there is a large grey area.

4. The first step in avoiding the reciprocal trust doctrine is for husband and wife to create the trusts at different times. If the clients do not want to leave one spouse out as a beneficiary of the other's trust, then one spouse's trust should give the other beneficial interests that are meaningfully different. For example, assume wife is a discretionary beneficiary of income and principal in husband's trust, pursuant to an ascertainable standard. The wife's trust could do one or more of the following:

   a. Make the husband a discretionary beneficiary of income only.

   b. Allow distributions to the husband only in the discretion of an independent trustee.

   c. Allow distributions to the husband only if his income or net worth falls below a certain level.

   d. Limit the husband's interest to a 5 and 5 withdrawal power.

E. Domestic Asset Protection Trusts

1. Another option is to create a domestic asset protection trust in a state with a domestic asset protection trust statute.

2. The trust can be structured so that the transfer to it is a completed gift even though the settlor is a discretionary beneficiary of the trust. See Ltr. Ruls. 9332006; 9837007. This gives the beneficiary possible access to the trust if he or she needs it. However, the client must realize that most respectable corporate trustees in domestic asset protection states will not make distributions simply at the request of the settlor. The trustee will require some evidence of need or other good reasons to make the distribution.

3. In addition, the IRS has not ruled that a properly structured domestic asset protection trust will be excluded from the settlor's estate. Instead, the Service has indicated that it might apply Code Section 2036 to the trust, depending on the facts and circumstances. In particular, the IRS could consider how frequently the settlor accessed the trust, and whether there was evidence of the trustee simply deferring to the settlor's requests.

American Bankers Association
Briefing

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Tales from the Crypt: A Review of Past Mistakes by Lawyers, Accountants, Trust Professionals and Other Estate Planning Professionals

I. Marital Deduction

A. In a marital trust, income is a life sentence.

Estate of Walsh v. Comm'r., 110 T.C. No. 29 (1998). No marital deduction for trust when the surviving spouse's right to income and principal terminated if he became incompetent.

Mr. and Mrs. Walsh had executed a joint revocable trust as their primary estate planning document. The trust agreement created a marital trust at the first spouse's death which gave the spouse a right to all the trust income, a lifetime power to withdraw the principal of the trust, and a general power of appointment. However, the agreement further provided that the spouse's rights to income and principal terminated if he became incompetent, and at that point the trust property would be distributed as provided under the power of appointment, if exercised, otherwise to the couple's children. Apparently, the reason for terminating and distributing the trust upon the surviving spouse's incapacity was to permit that spouse to qualify for Medicaid without depleting the family assets.

This limitation of the spouse's interests after incompetency made the trust a terminable interest, thereby disqualifying it for the marital deduction. Among the arguments made by the estate in Tax Court was that a marital deduction savings clause provision, which stated the couple's intent that the trust qualify for the marital deduction, required that the court interpret the trust consistent with that intent. The Tax Court responded that "the mere fact that settlors meant Trust A to qualify for the marital deduction does not mean that it does so qualify..."

Roels v. United States, 928 F. Supp. 812 (E.D. Wis. 1996). No marital or charitable deduction when spouse's right to income ceases upon remarriage.

This case serves as a powerful reminder that form over substance does matter when it comes to qualifying property for the marital or charitable deductions. In Roels, the decedent's estate did not qualify for either deduction even though the entire residuary estate passed in trust for the surviving spouse, with the remainder passing to charity. That is because the trust for the surviving spouse provided that she would receive the entire income of the trust until her death *or remarriage*. Upon her death or remarriage, the balance of the trust would be distributed to four designated charities.

The trust did not qualify for the marital deduction because the surviving spouse's interest was a terminable interest: it would cease upon her remarriage. The trust did not qualify for any of the exceptions to the terminable interest rule. In particular, it did not qualify as a charitable remainder trust, because the spouse's interest was not for life or for a term of years and was not in the form of an annuity or unitrust interest.

The primary argument advanced by the estate in this case was that it would be contrary to the spirit of the law to deny a marital and charitable deduction when the entire residuary estate will pass only to the spouse or to qualifying charities. The court held that there are specific ways provided in the Internal Revenue Code to create deductible interests in a spouse and charity, and that since the decedent did not take advantage of these legislated options, no deduction was available. As a result, the estate paid $358,846 in estate taxes that, with fairly simple planning, could have been avoided.

The IRS and the courts are unforgiving when it comes to obtaining the marital or charitable deduction. The practitioner must satisfy the statutory requirements to obtain the deductions.

B. Davis v. Commissioner, 394 F.3d 1294 (9th Cir. 2005). Trust does not qualify for marital deduction because surviving spouse not given unrestricted right to all income.

This was a case where a marital deduction savings clause – a clause in the document stating that the decedent intends that the trust qualify for the marital deduction – may have been able to preserve a marital deduction, if it had been included.

The decedent, Ralph Davis, had a 1993 Will and Declaration of Trust that left all his property to his daughters. He then got remarried and amended his estate plan in 1996 to create a trust for his new wife, Evelyn Davis. Paragraph 2 of the Trust Amendment was titled "Life Estate to Surviving Spouse of Trustor." It stated that during his spouse's life, the trustee,

"shall pay to or apply for the benefit of the surviving spouse, in quarter annual or more frequent installments, all of the net income from the trust estate as the trustee, in the trustee's reasonable discretion, shall determine to be proper for the health, education, or support, maintenance, comfort and welfare of grantor's surviving spouse in accordance with the surviving spouse's accustomed manner of living."

Later paragraphs provided for the discretionary distribution of principal and stated that the trustee could consider the other income or resources reasonably available to a beneficiary in determining whether to make distributions. Mr. Davis named Evelyn as the initial trustee.

The IRS denied the marital deduction for the $564,862 allocated to the trust on the grounds that Evelyn Davis did not have a mandatory income interest. The court agreed. It concluded that Evelyn did not have an unrestricted right to the income in accordance with the regulatory standard. See Treas. Reg. §20.2056(b)-5(f)(8) (spouse "must have such command over the income that it is virtually hers"). The court distinguished Estate of Ellingson v. Commissioner, 964 F.2d 959 (9th Cir. 1992), where it concluded that the spouse had the equivalent of a mandatory income interest where the standard for distribution of income was "needs, best interests and welfare." It concluded that the standard was more restrictive in this case.

The court also concluded that the taxpayer could not rely on a state statute to argue that the trust should be deemed to be reformed to qualify for the marital deduction because there was nothing in the trust to indicate that Mr. Davis intended to qualify the trust. The court said "[h]ere, neither the Declaration of Trust nor the Amendment contains any language suggesting that Mr. Davis intended the interest passing to his surviving spouse in trust to qualify for the marital deduction." If there had been a boiler-plate marital deduction savings clause, it might have allowed the court to reach a different conclusion.

Finally, the court also concluded that the trust could not be saved by the fact that Evelyn Davis was named as initial trustee. It pointed out that she could become disabled at some point and no longer act as trustee. It said that while the distribution language was broad (possibly broad enough to be considered a general power of appointment over the income under Section 2041), it was not so broad as to satisfy Section 2056.

C. Current benefits, even indirect ones, for someone other than a spouse, can negate the marital deduction.

Estate of Rinaldi v. United States, 38 Fed. CL 341, 80 A.F.T.R.2d 97-5324 (1997). Marital trust that contains stock subject to potential bargain sale to third party not entitled to QTIP treatment.

One of the fundamental requirements of any marital deduction trust is that the surviving spouse must be the only beneficiary of the trust during his or her life. In furtherance of this requirement, in a general power of appointment marital trust, no one except the surviving spouse can appoint the trust property during the spouse's life to another person. In a QTIP trust, not even the spouse can have a lifetime power of appointment. Rinaldi illustrates a subtle application of this principle: if a third party has the ability to acquire marital trust property at a bargain price, that individual is treated as if he or she has an interest in the trust as a possible appointee of the trust property. If the trust property can be appointed to a third party, then the trust will not qualify for the marital deduction.

At the time of his death, Mr. Rinaldi held a controlling interest in the Rinaldi Publishing Company, of which his son was chief executive officer. Under Rinaldi's will, his stock in the company would be allocated to a QTIP marital trust for his wife. The will directed that, if certain events occurred, the trustee was to offer to sell the stock to the son at book value, which, at the time the will was executed, was below the fair market value of the stock.

The IRS disallowed the marital deduction for the QTIP trust because of the possibility that the shares allocated to the trust would be sold to the decedent's son for less than fair market value. The IRS took this position even though the company had agreed to redeem the shares from the trust at full value shortly after it was funded, ostensibly in order to preserve a previously made S corporation election. (It was not clear why the parties thought a redemption was necessary; the QTIP trust would qualify as a QSST.) The redemption agreement was entered into before the filing of the federal estate tax return and consummated shortly after the filing. The estate argued that because the parties arranged a redemption of the shares at fair market value, resulting in the trust holding

money and not stock, the offending bargain sale provision should be ignored. The court pointed out there was no legal impediment to the trust reacquiring the shares and entering into the mandated bargain sale with Rinaldi's son. However remote that possibility may be, QTIP eligibility must be based on the certainty that the property cannot be appointed to, or used for the benefit of, anyone other than the surviving spouse.

Letter Ruling 8843004 (July 27, 1988). Bargain sale provisions in a marital trust disqualify the trust for the marital deduction.

The decedent's will gave his spouse a life interest in their residence and the remaining assets of the residuary trust. Under the terms of the residuary trust, if the spouse ever decided to vacate the residence, the trustee was required to sell the residence to the decedent's child for approximately one-half the date of death value. In addition, the trustee was directed to use the trust property to finance the child's purchase of the residence at rates substantially below the existing market rates.

In order to qualify a trust for QTIP treatment, Section 2056(b)(7)(ii) requires that the surviving spouse be entitled to all of the income from or use of the marital trust property. In addition, no beneficiary, other than the surviving spouse, may receive any benefit from the property during the surviving spouse's lifetime. In this ruling, if the residence was sold and the child exercised his right to purchase the house at the specified below market price, the trust assets would accrue to the benefit of the child to the extent of the difference between the sale price of the residence and its fair market value, and to the extent the trustee loaned other trust assets to the child at below market rates.

Letter Ruling 9226059 (March 31, 1992). Surviving spouse's right to disclaim interest in QTIP trust disqualifies trust.

This letter ruling presents a trap for the practitioner who routinely includes explicit provisions granting the surviving spouse the right to disclaim his or her interest in the marital trust. If the disclaimer right is not limited in duration, it could disqualify the trust for the marital deduction.

The surviving spouse in this letter ruling had the right to disclaim any part or all of her interest in a marital trust at any time and from time to time during her lifetime, whereupon the disclaimed property would pass to a charity designated in the trust instrument. However, under relevant state law, in the absence of a provision in the trust, a disclaimer would have had to be filed within 10 months after the trust settlor's death. The IRS ruled that the right given to the surviving spouse under the trust therefore exceeded the limitations provided by local law, which caused her power to be "tantamount to a specific authorization allowing the spouse to appoint interest in corpus to a specified third party [the charity]." This power violates Section 2056(b)(7)(B)(ii)(II) of the Code, which states that property passing to a marital trust will qualify for the QTIP election only if no person (including the surviving spouse) has the power to appoint any part of the trust property to any person other than the surviving spouse during the spouse's lifetime.

This issue has arisen again in a pending federal estate tax audit. In that case, the trust instrument provides that the surviving spouse may disclaim any part or all of her interest in a QTIP marital trust "at any time and from time to time, during her lifetime." Applicable state law provides no statutory time limits on disclaimers, but has been construed to require that disclaimer must be made within a "reasonable time." The IRS has threatened to disqualify the marital trust from QTIP treatment, arguing that the disclaimer right granted to the spouse exceeds the limitations imposed by state law, since it may be exercisable beyond a reasonable time period. The IRS's position suggests that any provision granting a surviving spouse the right to disclaim property otherwise passing to marital trust be explicitly limited so that it does not exceed applicable local law. The right to disclaim property in accordance with state or local law is not deemed a power to appoint that property for purposes of Section 2056(b)(7)(B)(ii)(II).

D. The court saves the day.

Letter Ruling 200024015 (June 16, 2000). Court ordered reformation of trust to remove general power of appointment over trust share prevents inclusion of share in surviving spouse's estate.

Prior to his death, the decedent executed a revocable trust agreement. At the decedent's death, a residuary marital trust was to be established, consisting of two shares. The decedent's apparent intent was to have QTIP marital deduction treatment elected for one share, but not for the other, so that the second share could be sheltered by the decedent's applicable exclusion. However, the trust instrument gave the surviving spouse a testamentary general power of appointment over both the qualified and non-qualified shares.

Upon the decedent's death, the attorney for estate noticed the incongruity in having a testamentary general power of appointment for both the qualified and non-qualified shares. He contacted the draftsperson who stated that he had made an error. The draftsperson indicated that he should have only given a general power of appointment to the spouse over the qualified share of the trust. The executor commenced a state court reformation proceeding in which the court enjoined the surviving spouse from exercising the power of appointment as to the non-qualified share of the marital trust and limited the general power of appointment to the qualified share.

The estate asked for ruling that the power of appointment would not be considered a general power of appointment for the non-qualified share. The IRS held that it would not be. Apparently it accepted the claim that the deficiency in the trust was due to a drafting error.

One issue that the letter ruling did not address is whether the decedent spouse could give the surviving spouse a testamentary general power of appointment over the qualified share and still qualify for the marital deduction under Section 2056(b)(7) as a QTIP trust. Normally, the trust would qualify for the marital deduction under Section 2056(b)(5) because the surviving spouse was entitled to all the income for life and had a testamentary general power of appointment. The draftsperson in this ruling apparently

did not understand the difference between a life estate/power of appointment trust and a QTIP trust and the requirements for each.

E. It helps to read the document.

<u>Estate of Posner v. Commissioner</u>, T.C. Memo. 2004-112 (May 10, 2004). Trust for which marital deduction allowed in estate of first spouse to die not included in estate of surviving spouse because spouse did not have general testamentary power of appointment under state law.

In his will, Nathan Posner provided for one-half of his estate to be placed in marital trust for the benefit of his surviving spouse. Mr. Posner died in 1975 when the life estate/power of appointment trust was the standard form of marital deduction trust. Mr. Posner's will lacked all of the provisions necessary for the marital deduction. In fact, the marital trust contained no provisions relating to the distribution of the assets. The will did contain a provision expressing Mr. Posner's intent that the trust qualify for the marital deduction and stating that no power or discretion should be exercised that would, "(a) adversely affect the qualification of the marital trust, (b) prevent my estate from receiving the benefit of the maximum marital deduction, or (c) affect the right of my said wife to all income therefrom or her right to dispose of the principal and income thereof in the amount and to the extent necessary to qualify the marital trust for the marital deduction for Federal estate tax purposes under the provisions of the law applicable to my estate." Based on this provision, Mr. Posner's estate claimed a marital deduction for the marital trust, despite the lack of the necessary provisions. The IRS audited the return and allowed the marital deduction for the trust.

Before Mrs. Posner passed away, she had a falling out with her two daughters. As a consequence, she chose to disinherit them in her will and leave most of her estate to her son and to charities. Believing that she had a testamentary general power over the marital trust (as is typical of life estate/power of appointment trusts), she left the entire trust, valued at approximately $5 million, to be paid into her revocable trust and distributed in accordance with her estate plan. To one daughter she left $100; to the other she left only a photograph. Mrs. Posner's daughters disputed the existence of the general power of appointment, and the state appellate court ruled that, as a matter of state law, Mrs. Posner did not have the power. As personal representative, her son then filed for a refund of estate taxes on the grounds that the marital trust should be excluded from Mrs. Posner's estate, since she had no general power of appointment over the trust to cause its inclusion.

Despite the allowance by the IRS of the marital deduction in Mr. Posner's estate, the Tax Court allowed Mrs. Posner's estate to exclude the trust from her estate. It followed the state court's conclusion that Mrs. Posner lacked either a testamentary or an inter vivos power of appointment over the marital trust. The court found that failure to include any of the necessary substantive provisions in the will was more than a mere scrivener's error. The will did not expressly provide for the disposition of income or principal of the marital trust, and contained no direction regarding the distribution of the principal upon termination of the trust. The court reviewed the state court decision and applicable

Maryland law, and concluded that reference to the marital deduction alone was insufficient to create a general power of appointment or otherwise qualify the trust for the marital deduction in Mr. Posner's estate.

In addition, relying on Southern Pacific Transportation Company v. Commissioner, 75 T.C. 497, 560 (1980), the Tax Court held that the duty of consistency did not apply in this case. The court found that the crucial facts were known to both parties and the erroneous deduction was due to a mutual mistake of law. Pursuant to the state court ruling, the marital trust property reverted back to Mr. Posner's estate to be divided equally among his three children according to the residual clause of his will.

F. Disclaimers must be done carefully.

Estate of Katz v. Commissioner, T.C. Memo 2004-166 (July 14, 2004). Disclaimer by spouse causes overfunding of nonmarital trust and an estate tax to be due.

This clearly was a case of bad advice to the surviving spouse after the decedent's death. The decedent's will contained a pecuniary credit shelter bequest, allocating to the nonmarital trust the maximum amount of property that could be transferred to the trust without incurring federal estate tax. The clause stated, "This amount shall not be reduced on account of any disclaimer by my wife." A later provision, in the residuary marital disposition, stated that any property from the residuary disclaimed by the spouse would be added to the nonmarital trust.

The surviving spouse wanted to make sure that certain assets were used to fund the nonmarital trust. She apparently was advised that she could ensure this by disclaiming those assets, which consisted of significant holdings in five different stocks. Whoever advised her thought the disclaimer would move the stocks to the nonmarital trust, and the formula then would operate to add only whatever additional property was necessary to cause the nonmarital trust to equal the decedent's applicable exclusion amount, after first taking the stocks into account.

Of course this is not what the formula said. It said that the allocation to the nonmarital trust "shall not be reduced on account of any disclaimer by my wife." In effect, the disclaimer double-funded the nonmarital trust. This is exactly how the IRS treated it when they assessed an estate tax. The estate representative tried to argue that the intent of the decedent was to pay no estate tax. The court would have none of that. It, correctly, pointed out that there was nothing wrong with the formula in the will. The overfunding was caused solely by the disclaimer by the spouse, which she did voluntarily. Therefore, the estate owed estate tax of $147,800.

G. You must read the tax clause.

<u>Estate of Lurie v. Commissioner</u>, T.C. Memo 2004-19, affirmed, 425 F.3d 1021 (7th Cir. 2005). Silence of tax clause in will results in apportionment of estate taxes against marital trust, resulting in diminution of marital gift.

This case illustrates that tax clauses cannot be treated as "boilerplate" provisions in an estate plan, particularly in complex, high net worth estates. That happened in the case of Robert Lurie's estate plan. The consequences were disastrous, because the draftsperson of his testamentary plan did not take into account the impact of certain trusts that had been created as part of Lurie's lifetime planning. As the Seventh Circuit put it, "[t]his case is an example of the how the best laid plans of mice and men can often go awry."

Robert Lurie was a successful Chicago businessman who died in 1990. It appears that he had engaged in planning long before his death involving the creation of multiple irrevocable trusts with nominal grantors other than Lurie, but which trusts largely were funded by Lurie. He had exercised lifetime powers over these trusts to create new trusts. His will, as is often typical, provided that tangible personal property was to go to his spouse with the balance of his estate going to the revocable trust. The tax and expense clause in the will provided that taxes and expenses were to be paid from the residue of his estate, but was silent about what would happen if the taxes and expenses exceeded the residue of his estate.

The revocable trust created an A/B estate plan. However, the credit shelter trust was not funded because Lurie had used up his applicable exclusion amount with lifetime gifts. Thus, only a marital trust was created for the benefit of Lurie's spouse. The tax and expense clause in the trust directed that if the estate lacked sufficient assets to pay taxes and expenses, these should be paid first from the trust principal other than the marital trust, but without reimbursement from any other party. Thus, the marital trust was to be used to pay taxes as a last resort.

On his estate tax return, Lurie's estate reported a gross estate of approximately $92 million and took a small deduction for expenses and about $91.7 million for the gift to the marital trust. In the view of the estate, no taxes were owed.

The IRS believed that the trusts created by Lurie through his exercises of the powers of appointment in 1983 and 1990 were includable in his gross estate. These trusts had a value of approximately $40 million. If the trust had contained a tax reimbursement clause that applied to Section 2036 property, the inclusion of the $40 million of trust property would have resulted in about $22 million of estate tax, payable from those trusts. The IRS issued a deficiency notice and said that because taxes were payable from the marital trust, the marital deduction was reduced to approximately $44 million and the estate owed approximately $48 million in additional estate tax.

The estate acknowledged that the power of appointment trusts were includable in Lurie's gross estate but argued that those trusts should pay the tax. The estate contended that Lurie's will was the only document that mattered in determining how taxes should be

paid and that the tax clause in the revocable trust should be ignored. Since the will failed to specify how taxes should be paid, equitable apportionment would apply under Illinois law and the power of appointment trusts would be liable for the tax.

The Tax Court and the Seventh Circuit disagreed that only the will should be examined. It concluded that the tax clause in Lurie's revocable trust was relevant, especially since the trust and will were executed at about the same time. The Seventh Circuit found that the will and revocable trust had to be read together and that there were only two potential sources of taxes: the probate estate and the revocable trust. The Seventh Circuit held that Lurie intended that tax be paid from either the probate estate or the revocable trust, but not from the power of appointment trusts.

Although the Seventh Circuit acknowledged that Lurie and his advisors failed to anticipate that the power of appointment trusts would be included in his estate and trigger tax, the court felt that it had to apply the terms in the trust instrument as written and not speculate as to what Lurie might have done under different circumstances. The court could not rewrite Lurie's will and trust to give effect to what Lurie would have done. Thus, the terms of the trust as written had to be applied.

Obviously, the "very best resources" were not good enough here. Lurie is a forceful example of the need to pay attention to the provisions of tax and expense clauses, rather than relying upon boilerplate provisions that are often found in the forms that estate planners use.

H. The IRS rides to the rescue.

Letter Ruling 200702081 (January 12, 2007). IRS finds QTIP election void with respect to which an unnecessary QTIP election was made.

An individual created a revocable trust. Under the terms of the revocable trust, certain specific gifts were made at the individual's death. After providing for the specific gifts, the remaining property was to be divided between a marital trust for the surviving spouse, which would pass free of tax because of the unlimited marital deduction, and a family trust for the benefit of the surviving spouse which would be sheltered from estate tax by the individual's remaining applicable exclusion amount. However, on the individual's federal estate tax return, a QTIP election was made for the entire date-of-death value of the trust. Upon realizing its mistake, the executor requested the IRS to ignore the QTIP election made with respect to the specific bequests and family trust as unnecessary. For example, the QTIP election with respect to the family trust would cause the family trust assets to be taxed unnecessarily at the surviving spouse's death.

The IRS, citing Revenue Procedure 2001-38, 2001 C.B. 1335, stated that the QTIP election for the specific gifts and the family trust would be treated as null and void when the election was unnecessary to reduce the estate tax liability to zero. As a result, no adverse estate tax consequences occurred because of the unnecessary QTIP election. This is just one of many rulings in which the IRS has found a QTIP election void because it was unnecessary to reduce the estate tax in a decedent's estate to zero.

Letter Ruling 200832011 (August 8, 2008). IRS permits recalculation of the amount for which a QTIP election was made.

Upon decedent's death, the residue of the estate passed into a separate trust for the benefit of the surviving spouse. During the surviving spouse's life, the spouse would receive all the income from the trust. Upon the surviving spouse's death, the property remaining in the trust was to be distributed equally to the decedent's children. It was recognized that a QTIP election would be made for the portion of the trust that would not be sheltered from tax by decedent's applicable exclusion amount.

A lawyer was hired to prepare the federal estate tax return and intended to make a QTIP election on the federal estate tax return in the amount necessary to reduce decedent's estate tax to zero after taking full advantage of decedent's applicable exclusion amount. The lawyer made a mistake in determining which applicable exclusion amount should be used and assumed that the amount of the applicable exclusion was greater than what it actually was. The decedent died in a year in which the applicable exclusion amount was a certain amount. The lawyer prepared the estate tax return in the following year when the applicable exclusion amount had increased and mistakenly used the higher applicable exclusion amount available in the year following the year of the decedent's death. As a result, the QTIP election was insufficient to reduce the estate tax to zero.

For example, decedent dies in 2005 when the applicable exclusion amount was $ 1.5 million. Decedent's estate is $5 million and passes to a trust providing mandatory income payments to the surviving spouse. Lawyer prepares the federal estate tax return in 2006 when the applicable exclusion amount increased to $2 million. On the federal estate tax return, lawyer elects QTIP treatment for $3 million, assuming that the applicable exclusion amount would shelter the other $2 million. Because the applicable exclusion amount is actually $1.5 million, a QTIP election of $3 million subjects $500,000 to tax. The QTIP election should have been $3.5 million in order to fully reduce the federal estate tax to zero.

When the mistake was discovered, the estate filed a supplemental federal estate tax return which corrected the amount of the applicable exclusion and elected QTIP treatment for a sufficient amount of property in the trust to reduce the estate tax liability to zero. The IRS approved the estate's request that the marital deduction would be allowable with respect to the amount (as re-computed) necessary to reduce the decedent's estate tax liability to zero based on the correct applicable exclusion amount.

I. The surviving spouse must survive to get the marital deduction.

<u>Estate of Lee v. Commissioner</u>, T.C. Memo. 2007-371. Tax Court denies marital deduction for property passing to spouse who predeceased the decedent.

Mr. and Mrs. Lee suffered from a serious and ultimately fatal disease when their estate planning was performed. At the time that the estate planning was done, most of the assets were held in Mr. Lee's name. The joint assets and the assets titled in Mrs. Lee's name constituted a minimal portion of the combined estates. Mrs. Lee died on August

15, 2001. Mr. Lee died subsequently on September 30, 2001. Although it was not stated specifically in Mr. Lee's will, the apparent intention was that Mrs. Lee be deemed to have survived Mr. Lee, if Mr. Lee died within six months after Mrs. Lee's death. In this way an A/B plan could be implemented with a credit shelter trust for Mrs. Lee and the children and an outright marital gift to Mrs. Lee.

After their deaths, Mr. and Mrs. Lee's separate estates were administered as if Mr. Lee had predeceased Mrs. Lee. A credit shelter trust was established for the benefit of Mrs. Lee and their children and the residue of Mr. Lee's estate was transferred to Mrs. Lee as if she were still alive. Mr. Lee's estate tax return claimed the marital deduction for the residue that was transferred to Mrs. Lee.

Upon audit, the IRS denied the marital deduction and determined an estate deficiency of $1,020,000 and imposed an accuracy related penalty of $204,000 and an additional tax of $255,000 for an untimely filing.

The Tax Court, on a motion for summary judgment, found that the marital deduction requires an actual surviving spouse to meet the requirement in Section 2056(a) that the marital deduction is available for interests in property passing from the decedent to the surviving spouse. Because Mrs. Lee died 46 days before Mr. Lee, Mr. Lee left no surviving spouse. Consequently, Mr. Lee's estate was not entitled to benefit from the marital deduction. The wills of Mr. and Mrs. Lee could not operate to change the order of death. The Tax Court also noted that the term "survivor" is not defined in the Internal Revenue Code. Consequently, it must be given its ordinary and customary meaning of one who outlives another. Moreover presumptions of death only apply when the actual order of death cannot be determined. Treas. Reg. § 202056(c)-2(e) provides that a presumption, whether supplied by local law, a decedent's will, or otherwise, may operate to determine the order of the deaths of spouses if the actual order of their deaths cannot be determined. This was not a case in which the actual order of deaths could not be determined.

J. Funding the Marital Trust and the Credit Shelter Trust would seem elementary.

<u>Estate of Olsen</u>, T.C. Memo 2014-58. IRS holds that assets in a QTIP Trust should be included in the estate of the surviving spouse.

Wife died in 1998. Under her estate plan, a credit shelter trust and two marital trusts were funded. $1 million went to Marital Trust A, $505,000 went to Marital Trust B, and $600,000 to a Family Trust. A QTIP election was made for Marital Trust A and Marital Trust B on the federal estate tax return for Wife. Husband was named as trustee of the three trusts.

After Wife's death, Husband failed to fund the three separate and distinct trusts. Subsequently, Husband withdrew funds totaling $1,475,000, including a charitable contribution to a college, a second charitable contribution to a college, and a withdrawal that was deposited into one of his personal accounts. Husband died on February 25,

2008. One of Husband's sons acted as executor and trustee. Son then created the three separate and distinct trusts. He funded the Family Trust with all of the assets that remained after the two charitable contributions and the transfer to Husband's personal account. Son argued that the previous withdrawals had used up the assets that otherwise would have funded the two marital trusts. The IRS argued that no assets remained in the Family Trust at Husband's death since those assets were used in making the charitable gifts and the remaining assets should be treated as QTIP trust assets subject to estate tax in Husband's estate.

The court essentially split the difference. The court stated that the two withdrawals totaling $1,080,000 for the charitable gifts should be treated as having been made from the Family Trust and that the $394,000 withdrawal that was deposited in Husband's personal account should be treated as being made from the marital trusts. This was because the Family Trust gave Husband a special lifetime power of appointment to appoint principal to one or more charities, and the Family Trust was the only trust from which Husband could have made a gift to charity. Additionally, with respect to the marital trusts, principal could be paid to husband for health, education, support and maintenance which would permit the withdrawal by Husband for his personal use. The court ordered that the estate should include approximately $608,000 which was the value of the marital trusts on the applicable alternate valuation date after being reduced by the $394,000 withdrawal from the marital trusts.

II. Gifts

A. Gifts can occur even if no property directly changes hands.

Letter Ruling 9804047 (January 23, 1998). Spouse's failure to exercise a 10% noncumulative power of withdrawal over trust property is treated as a gift of the excess over the "5-and-5" amount.

Under the terms of her husband's irrevocable life insurance trust following his death, the spouse was to receive all the income for life as well as principal for her health, education, support and maintenance. In addition, the spouse had a noncumulative power to withdraw 10% of the trust principal each year.

The IRS ruled that, under Section 2514(e), the spouse would make a taxable gift each year she failed to exercise the withdrawal right to the extent that the value of the property subject to withdrawal exceeded the greater of 5% of the trust corpus or $5,000. Moreover, under Section 2702, the spouse's retained interests in the trust property (the rights to receive all the income and to receive principal under an ascertainable standard) were valued at zero for purposes of computing the gift. As a result, the spouse would be treated as making a gift equal to 5% of the value of the trust property each year she failed to exercise the power.

There are circumstances in which there is no detriment to granting a trust beneficiary a noncumulative power of withdrawal in excess of the 5-and-5 amount: for example, if the trust is for a child who is the primary or sole current beneficiary, the child has a

testamentary power of appointment over the trust, and it is not intended to be a generation-skipping trust. In this situation, there is no taxable gift upon lapse of the power because the child's testamentary power of appointment causes the gift to be incomplete. The lapses of the annual powers of withdrawal in excess of the 5-and-5 amount will cause some of the trust property to be included in the beneficiary's estate, but there is no harm in this if the property was going to be taxed at the beneficiary's death in any event.

B. The IRS does not approve of creative expansion of the annual exclusion.

Estate of Cidulka v. Commissioner, T.C. Memo. 1996-149, 71 T.C.M. (CCH) 2555 (March 25, 1996). Annual exclusion denied for gifts to daughter-in-law and grandchildren followed by gifts to son.

No one can deny the creativity of clients who want to minimize taxes. Many estate planning practitioners have had that conversation in which the client suggests that he or she can increase the amount of property transferred to a beneficiary tax-free through annual exclusion gifts by first giving property to other persons, who are then expected to retransfer that property to the desired beneficiary. This case shows the danger of trying to play fast and loose with the annual exclusion rules.

Mr. Cidulka had regularly made annual exclusion gifts of closely-held stock to his son and to his son's wife. After each gift, the wife immediately transferred the stock to her husband. Mr. Cidulka also made annual exclusion gifts of the stock to his two grandchildren. Mr. Cidulka owned 52% of the stock of the company. In 1982, he simultaneously transferred 10 shares each to his son, daughter-in-law, and two grandchildren, thereby reducing his interest below 50%, and then sold the remainder of his stock to the company for $370,000, or $964 per share. Each transfer, including the sale of stock to the company, was treated as a transfer of a minority interest.

The Tax Court held that the 1982 transfers were part of a single transaction to transfer a majority interest in the company to the son and should be valued as such. The son's wife immediately transferred her 10 shares to the son. Since she had consistently done this on numerous prior occasions, the Tax Court determined that there must have been an understanding that she would only act as a conduit to pass the shares through to her husband. Although the two grandchildren purportedly owned shares in the company, they were not listed as shareholders by the company, they received no distributions from the company, and when the company was liquidated in 1986, the son received the entire liquidating distribution from the company. Therefore, those gifts also were treated as indirect gifts to the son.

In this case, if the father had made bona fide gifts to the daughter-in-law and grandchildren, the interest transferred to the son could have been valued as a minority interest, rather than as a controlling interest. This case provides a good warning for

clients or estate planners who want to be too aggressive in their use of annual exclusion gifts.

<u>Heyen v. United States</u>, 945 F.2d 359 (10th Cir. 1991). Decedent's annual exclusion gifts of stock to 27 unrelated individuals, who immediately retransferred the stock to members of the decedent's family, constituted indirect gifts from the decedent to her family members.

Jennie Owen transferred shares of bank stock to 27 different persons who, after receiving the stock certificates, endorsed the certificates in blank and returned them to Jennie's daughter, Mrs. Heyen, or the bank. In each case, the bank then canceled the certificates and the stock was reissued to members of Jennie's family. Based on the book value per share, each of the 27 recipients received stock valued at slightly less than $10,000. The recipients either did not know they were receiving a gift of stock and believed they were merely participating in stock transfers, or had agreed before receiving the stock that they would endorse the certificates in order for them to be reissued to Jennie's family.

Jennie died nine months after the stock transfers. Mrs. Heyen, as her executor, filed a gift tax return that did not report the transfers. Upon audit, the IRS treated the transfers as a sham, and assessed a deficiency as well as a civil fraud penalty against Mrs. Heyen. Mrs. Heyen argued that her mother made separate gifts to the intermediate stock recipients, who voluntarily permitted retransfer of the stock to the family. She claimed that, because the gifts qualified for the annual exclusion, they were not subject to gift tax and no reporting was required. The Court ruled that it was proper to consider the evidence presented at trial that it was Jennie's actual intent to transfer the stock to her family. On the basis of this intent, and the substance rather than the form of the transaction, the Court found that Jennie made an indirect gift under Code Section 2511(a).

Mrs. Heyen also argued that she should not be subject to a fraud penalty merely because she filed a gift tax return that did not include the stock transfers. The IRS bears the burden of proving fraud by clear and convincing evidence. The Court found that the evidence indicated that Mrs. Heyen was a sophisticated taxpayer and that her mother wished to avoid gift taxes and intended that the stock return to the family. To further her mother's plan to avoid taxes, Mrs. Heyen contacted many of the 27 intermediaries in advance to determine whether they would be willing to effectuate retransfer of the stock to family members, and simply asked others at the time the stock was transferred to them to sign their names to blank certificates to facilitate a stock transfer to the family. The Court stated that her active effort to accomplish her mother's intention along with her sophistication regarding the tax matters at issue were consistent with a finding that she intended to evade taxes.

<u>Bies v. Commissioner</u>, T.C. Memo. 2000-338 (November 2, 2000). Annual exclusion gifts of closely held stock to two daughters-in-law and a granddaughter-in-law were in substance indirect transfers to decedent's sons and grandsons.

This case is factually similar to <u>Heyen v. Commissioner</u>, 945 F.2d 359 (10th Cir. 1991), in which a mother transferred shares of stock to numerous individuals using annual

exclusion gifts and the individuals, in turn, transferred their shares of stock to the daughter.

Marie Bies owned 75 of the 150 shares of the family's funeral home business. Two of her children, Albert and Gregory, and one grandchild, James, were employed by the funeral home. Mrs. Bies' attorney advised her to make annual exclusion gifts of stock to family members to ensure continued family ownership. Mrs. Bies worried about making gifts to children who were not in the business. Consequently, although Mrs. Bies had four children, she made gifts of stock only to Albert and Gregory. Upon the attorney's advice and to take fuller advantage of the annual exclusion, she also gave shares of stock to the wives of Albert and Gregory. Several years later, and until her death, Mrs. Bies also transferred shares of stock to her grandson, James, and his wife. Each transfer was the number of shares or fraction of a share calculated to be equal in value to $10,000. Upon receipt of their shares, each of the two daughters-in-law and the granddaughter-in-law transferred their shares over to their respective spouses, usually soon after they received the shares.

The IRS held that the transfers of stock to the two daughters-in-law and the granddaughter-in-law were in substance indirect transfers of additional shares to the sons and grandson. The Tax Court noted that it usually will not apply the substance over form doctrine in this kind of situation. However, it concluded that the evidence in this case showed that the transfers by the daughters-in-law and the granddaughter-in-law to their respective spouses appeared to be the result of a prearranged plan, and that the daughters-in-law and the granddaughter-in-law were merely intermediate recipients used to enable Mrs. Bies to transfer the stock to her two sons and grandson. As a result, those gifts to the in-laws would not qualify for annual exclusion treatment.

Sather v. Commissioner, T.C. Memo. 1999-309, 78 T.C.M. (CCH) 456 (1999). Annual exclusion gifts by brothers to each other's children are reciprocal gifts and annual exclusion is denied.

The Sather family owned a candy distribution business. The second generation consisted of four brothers, three of whom were married, each with three children of their own. Following consultations with their accountant and an attorney, each of the three named brothers created trusts for their children. The trusts presumably were Crummey trusts, because each brother and his wife then made gifts of stock in the family business to his trust and claimed annual exclusions for the gifts. Each brother and his wife also made annual exclusion gifts of stock in trust to their six nieces and nephews. The single brother also made annual exclusion gifts to all nine of his nieces and nephews. These gifts were made in 1992 and 1993.

The IRS denied the annual exclusion for the gifts to the nieces and nephews by the married brothers because the gifts were reciprocal in nature. The court agreed and stated its reasons for doing so as follows:

> "The simultaneous, circuitous transfers of identical property to the various nieces and nephews constitute gifts by the transferors to their own

> children. ... The substance and purpose of the series of transfers was for each married couple to give their own children their Sathers stock. ... Each niece and nephew received an identical amount of stock from his or her aunts and uncles and was left in the same economic position in relation to the others. This was not a coincidence but rather was the result of a plan among the donors to give gifts to their own children in a form that would avoid taxes."

The court identified the primary factors that give rise to application of the reciprocal trust or reciprocal gift doctrine as (1) interrelated gifts, which (2) are identical in type and amount and executed at the same time, and which (3) leave each beneficiary in the same position as they would have been if their parents had given the property directly to them. The court found that the gifts by the single brother, which were not reciprocal, did not eliminate the reciprocal nature of the other gifts.

C. A litigator may not a good estate planner make.

Hatleberg v. Norwest Bank Wisconsin, 700 N.W. 2d 15 (Wis. 2005). Trustee held liable for negligently providing information to settler in course of trustee's business or profession.

A trust officer at the bank advised one of its clients on her estate planning after the death of her husband. Upon its advice, the customer, Mrs. Erickson, established a revocable trust with the bank as trustee. The trust officer also recommended that Mrs. Erickson establish an irrevocable trust to reduce her estate tax by taking advantage of the gift tax annual exclusion. Mrs. Erickson decided to set up an irrevocable trust and, while the trust officer offered to refer her to an attorney whom he believed to be a specialist in estate planning, Mrs. Erickson decided that she would have her neighbor draft the instrument. The neighbor was not experienced in estate planning but he drafted the trust using a form book. Although the trust was intended to reduce estate taxes by taking advantage of the gift tax annual exclusion, it lacked Crummey Powers to create the necessary present interest for the gift tax annual exclusion. The trust was established in 1985 and Mrs. Erickson contributed $40,000 to the trust each year for eleven years.

The trust officer noticed the absence of the Crummey Powers in 1988 and notified the attorney of the omission with a handwritten note. Until that time, the attorney had never heard of Crummey Powers. The attorney replied to the trust officer that he believed that the trust was adequate as written and that the trust officer's concern was irrelevant as it was too late to add Crummey Powers to the trust. The attorney also believed that the trust was completely funded and that Mrs. Erickson would not make further contributions to the trust. Neither the attorney nor the trust officer informed Mrs. Erickson of their concerns about her trust. Instead, the trust officer, in later years, advised Mrs. Erickson to continue to make contributions to the trust. In fact, in a 1991 letter, he stated that Mrs. Erickson could make gifts that qualified for the $10,000 annual exclusion.

By the time of her death, Mrs. Erickson had contributed $440,000 to the trust over an eleven year period. Upon her death, her estate had to recapture the $440,000 in gifts and

pay $173,644 in additional estate taxes. The executor of Mrs. Erickson's estate sued both the attorney and the bank. The attorney settled, but the bank contested its liability.

The court first found that the bank did not have duty to review the trust to ensure that it worked for its intended purposes. The court primarily based this part of the decision on the fact that the bank did not draft the trust. The court also declined to decide if the bank's notice to the attorney relieved it of liability. Instead, the court found that the bank had negligently provided information to Mrs. Erickson when, despite its knowledge of its problems with the trust, it stated, for example in 1991 (long after the discovery of the omission of the Crummey Powers), "for estate tax purposes, it makes sense to do the gifts." The bank officer told Erickson to continue contributing to the trust even though the bank officer knew that the trust was defective for her objectives and that was sufficient to make the bank liable.

D. A gift must be complete to be effective.

Estate of Newman v. Comm'r., 111 T.C. No. 3 (1998). The value of outstanding checks prepared by decedent's attorney in fact prior to the decedent's death, but paid after death, were includible in the decedent's gross estate.

Prior to the decedent's death, the decedent's son, acting under a durable power of attorney, drew six checks on the decedent's checking account payable to family members and other individuals to make annual exclusion gifts. The drawee bank neither accepted nor paid the checks until after the decedent's death. The Tax Court rejected the estate's arguments that the checks constituted non-taxable completed gifts that should be excluded from the gross estate.

The estate argued that the checks should be excluded from the decedent's estate based on Metzger v. Comm'r., 38 F.3d 118 (4th Cir. 1994). In Metzger, a son, pursuant to a power of attorney given by his father, made $10,000 gifts to himself and his wife in December of 1985. The son and his wife deposited the checks on December 31, 1985, but they did not clear until January 2, 1986. The son made additional $10,000 gifts on behalf of his father to himself and his wife in 1986. These checks both were deposited and cleared in 1986. There was a question of whether the checks written in 1985 were to be treated as made in 1985 or 1986 for annual exclusion gift purposes. The Fourth Circuit in Metzger held that since the checks were unconditionally delivered, properly presented for payment and duly paid upon presentment, the payment of the checks related back to the date of delivery and were treated as being made in 1985. Prior to Metzger, the relation back doctrine had not applied to noncharitable donees.

The court in Newman distinguished Metzger and refused to apply the relation back doctrine. Unlike the situation in Metzger, the decedent in Newman died before the checks were presented and paid by the drawee bank. Also, under local law, the checks were considered a conditional payment until accepted by the drawee bank. Since the decedent maintained dominion and control over the checking account funds until her death and could have revoked the checks until the drawee bank accepted or paid them, the court found that the gifts should be included in her estate.

In Revenue Ruling 96-56, 1996-2 C. B. 161, the IRS partially reconsidered its position with respect to non-charitable donees in light of Metzger. Under this revenue ruling, a gift by check would be deemed complete on the date on which the donee deposits its, cashes the check against the available funds of the donee, or presents the check for payment, if five requirements were met. The five requirements were:

(1) the check was paid by the donor's bank when first presented for payment;

(2) the donor was alive when the check was paid by the donor's bank;

(3) the donor intended to make the gift;

(4) the donor's delivery of the check to the donee was unconditional; and

(5) the check was deposited, cashed or presented for payment within the calendar year for which completed gift treatment is sought and within a reasonable time for issuance.

This ruling did not help the taxpayers in Newman since the donor died before the checks were paid. This still will be treated as an incomplete gift, unless local law provides otherwise.

Estate of Goldman v. Commissioner, T.C. Memo. 1996-29, 72 T.C.M. (CCH) 373 (January 25, 1996). Gifts made pursuant to power of attorney are included in estate because no specific authority was granted to make gifts.

In recent years the IRS has attempted to recapture in a decedent's gross estate gifts made by an agent pursuant to a durable power of attorney that did not expressly grant the power to make gifts. In most jurisdictions, it remains necessary to include a specific provision in a power of attorney authorizing the agent to make gifts. This case and ruling reemphasize this point.

In Estate of Goldman, Mrs. Goldman was diagnosed with cancer in 1989, and executed a standard form power of attorney at her bank naming her daughters as her agent. The power of attorney gave the agents the power to open and operate bank accounts, to make deposits, to cash or endorse checks, to write checks and withdraw funds, and "to do anything he or she considers necessary and proper to conduct this business with the Bank, even if it for the Attorney's own benefit, as if I were personally doing it." The power of attorney did not explicitly list the power to make gifts.

Throughout December 1990 and January 1991, Mrs. Goldman wrote numerous checks herself, including charitable contributions and small birthday and holiday gifts that did not exceed $500. During that time, one of the daughters, acting as agent, also wrote sixteen $10,000 gift checks to various family members.

The estate argued that the decedent intended to make the gifts and that the daughter was authorized to make the gifts by the power of attorney. The Tax Court first concluded that it was highly suspect that Mrs. Goldman had intended to make the gifts. During the

relevant period, she was competent enough to write other checks and to make small gifts to relatives. The court found that it was unlikely that she would make the effort to write small checks to her relatives and pay routine bills, but ask her daughter to write the larger checks on her behalf. Next, the Tax Court held that a New York court would invalidate the transfers because there was no specific authority in the power of attorney granting the power to make gifts. Since the gifts were voidable by the decedent, the $160,000 in gifts made by the agent were brought back into the decedent's estate.

This case serves as a reminder that powers of attorney should specifically grant the agent the power to make gifts if the principal intends to allow the agent to continue a gift-giving program in the event of the principal's disability. The power can be limited to the power to make annual exclusion gifts, or to gifts in line with those the principal regularly makes. Although in some states a broad grant of power to an agent will be construed as including the power to make gifts, it is best to include the power to make gifts expressly in the power of attorney, rather than relying on state law.

Estate of Swanson, 46 Fed. Ct. Cl. 38 (March 13, 2000). Gifts pursuant to California durable general power of attorney lacking specific authority to make gifts are void.

Estate planning for a disabled individual often fails because the person and/or the lawyer did not anticipate the need to authorize it in advance. It is almost always possible to give a trustee or an agent under a power of attorney broad authority to make gifts or engage in other estate planning. As this case illustrates, though, courts are reluctant to impute such authority where it is not specifically granted.

In 1985, Mrs. Swanson, a widow, was declared legally blind. Thereafter her nephew, Dean Stubblefield, took over responsibility for the management of Mrs. Swanson's financial assets and real property. In 1989, Mrs. Swanson moved into a nursing home. On December 14, 1990, Mrs. Swanson executed a durable general power of attorney which purported to give Stubblefield the legal authority to manage and dispose of Mrs. Swanson's property and to conduct business on her behalf. No specific authority to make gifts was included. In the first week of February, 1991, Stubblefield wrote, signed and delivered 38 checks, made out to 38 separate individuals, in the amount of $10,000 each. Stubblefield claimed that the idea for the $10,000 checks arose in a discussion with Mrs. Swanson about reducing the tax impact on her estate. He stated that he came up with a list of 40 potential recipients and that Mrs. Swanson approved 38 of them by nodding her head when he read her each individual's name. Mrs. Swanson died on February 13, 1991.

The IRS asserted that the value of the gifts made pursuant to the power of attorney were includable in Mrs. Swanson's gross estate because they were beyond the scope of authority conferred upon Stubblefield under the power of attorney. The court agreed, finding that, under California law, a general power of attorney does not give the agent the authority to make gifts of the principal's property. The court thought that Mr. Stubblefield only could make the gifts if he was authorized to do so in writing. The court also found that Mrs. Swanson's nodding at the names of the donees did not constitute a ratification of the gifts, thus making them valid. As with many other cases and rulings,

the lesson from Swanson is that if an individual wants to be sure that an agent under a power of attorney will have the ability to make gifts, then that authority needs to be specifically spelled out in the power of attorney.

Pruitt v. Commissioner, T.C. Memo. 2000-287 (September 12, 2000). Gifts pursuant to Oregon durable power of attorney lacking specific authority to make gifts are valid.

The Pruitt case was one of the rare situations where the court concluded that an agent under a power of attorney had sufficiently broad authority to allow the agent to make gifts even absent a specific grant of the power. In this case, the result was largely due to the consistency of the gifts with the principal's past behavior.

From 1980 to 1992, Suzanne C. Pruitt made annual exclusion gifts to her daughters, their husbands, and her grandchildren as part of her estate planning. In 1987, and later in 1992, Mrs. Pruitt executed durable property powers of attorney under Oregon law in which she named her daughter, Sandra Thompson, as agent. Neither the 1987 power nor the two 1992 powers of attorney contained specific authorization for the agent to make gifts on behalf of Mrs. Pruitt. In 1993 and 1994, Sandra Thompson, under one or more of the powers of attorney, made gifts of interests in Mrs. Pruitt's real property to each of Mrs. Pruitt's three daughters (including Mrs. Thompson) and their husbands. Upon Mrs. Pruitt's death, the IRS, as it has done in similar cases where the powers of attorney lacked specific authority to make gifts, challenged the validity of the gifts made under the power of attorney.

These power of attorney cases require the court to try to determine the validity of the gifts under state law, in the absence of a specific authorization in the power of attorney. The Tax Court found that Oregon had not established, either through case law or statute, a bright line rule flatly prohibiting gifts by attorneys-in-fact to themselves or to third parties where there was no express written authorization in the powers of attorney. The court therefore looked at the facts surrounding the case to ascertain whether Mrs. Pruitt intended to confer the power to make gifts on her daughter, and if so, whether the gifts were within the scope of that authority. The court decided that the gifts under the power of attorney should be permitted for the following reasons: (1) no case law or statute prohibited an inferred power to make gifts; (2) the substantial pattern of gifts by Mrs. Pruitt when she was competent; (3) the consistency of the gifts under the power of attorney with the gifts made by Mrs. Pruitt herself; (4) the fact that the gifts did not deplete Mrs. Pruitt's assets to her detriment; and (5) the lack of fraud or abuse by the daughter.

The results in this case differed from the results in Swanson because the Tax Court interpreted Oregon law as being different from California law under the facts. The fact remains that the authority of the agent should be explicit, not left to the vagaries of state law.

E. Select the recipients of gifts carefully.

<u>Karpf v. Karpf</u>, 481 N.W. 2d 891 (Neb. 1992). A trustee breached his fiduciary duty to keep trust beneficiaries informed when the trustee failed to advise the beneficiaries of rights to exercise Crummey powers of withdrawal.

This Nebraska Supreme Court case shows that following the correct procedures in a Crummey trust is important not only for tax reasons. The trust involved in this case was one of a number created by the trustee's mother for the benefit of the trustee's children. Each trust granted Crummey powers of withdrawal over contributed property to the child, his spouse, and his issue. The child in question was divorced and his ex-wife sued the trustee, personally and on behalf of the minor children, because they had never been notified of the power to exercise their withdrawal rights.

The Court found that the trustee had breached his duty to keep the beneficiaries informed of all material facts concerning the trust. However, the Court ruled that no damages resulted from the breach. This conclusion was based in part on the ex-wife's testimony that she could not definitely say that she would have exercised the withdrawal rights if she had been informed. It also was based on the unrefuted evidence in the record that the settlor would have discontinued gifts to the trust, and possibly cut off other financial benefits, if any beneficiary had dared to exercise a withdrawal right. The son of the trustee, who was informed of the Crummey powers, testified that his father told him that if he "took anything out, it would be the last time." Another reason to follow the proper procedures with a Crummey trust is to avoid publicizing to the IRS testimony such as the foregoing. It would be interesting to know whether the grantor subsequently had his gift tax returns audited.

F. Gifts cannot be disguised as fees.

Letter Ruling 200014004 (April 7, 2000). Payment of excessive fees to the trustees of a QTIP trust constituted taxable gifts to the spouse's children who were acting as trustees.

This ruling comments on the tax consequences of fee payments from a QTIP marital deduction trust. The decedent who created the trust had died in 1988. The couple's two children were trustees of the trust. After the decedent's death, the primary asset of the QTIP trust was stock in a closely held company. A year after the decedent's death, the stock of the closely held company was sold to a third party. Following the sale of the stock, the trust assets were invested primarily in Treasury Bills. Later, the third party purchasers of the closely held stock filed for bankruptcy protection and the trustee in bankruptcy initiated a law suit against the trust relating to the 1989 sale of the stock. The children, as trustees, worked extensively with the attorneys hired to defend the lawsuit.

From 1991 through 1997, the children were paid trustees' fees. The spouse verbally agreed to the fees. As a result of the large fees, the trust expenses exceeded the trust income for each taxable year of the trust under review. Consequently, the spouse received no income during that time from the QTIP trust.

The IRS determined that the fees were in excess of what would be regarded as "reasonable" fees and that the spouse's consent to payment of the fees constituted a diversion to the children of income that she otherwise was entitled to receive. The IRS then ruled that the fees, to the extent they were excessive, were gifts by the spouse to the children.

To determine what portion of the fees were excessive, the IRS inquired of banks in the area to determine what a bank would charge as a trustee fee for a trust holding largely Treasury Bills. The IRS determined that a bank would have charged an amount equal to about 5% of the total fees paid to the children. The IRS gave no apparent weight to the fact that the trustees were engaged in litigation during this period, which might have justified a higher than usual fee. The IRS may have ignored this factor because it believed that the payment of fees was part of a plan to transfer assets to the children that would otherwise be subject to estate tax in the spouse's estate. There was no evidence cited to support this conclusion, however.

G. Free advice is just that.

Dickerson v. Commissioner, T.C. Memo 2012-60. Lottery winner made a taxable gift upon contributing a winning lottery ticket to a newly formed corporation in which she owned only 49% of the stock and other family members owned the rest.

Tonda Dickerson was a waitress at a Waffle House in Grand Bay, Alabama. Edward Seward, a regular customer of the Waffle House, gave lottery tickets to individuals including the petitioner and her co-workers. On March 7, 1999 Mr. Seward handed Tonda an envelope which turned out to contain a winning Florida lottery ticket. The ticket, if paid out over thirty years, was valued at $10,015,000 with a cash payout value of $5,075,961. The winning ticket was a gift and not a tip to Tonda.

Upon discovering that the ticket was a winning ticket, Tonda wanted to share it with her family with whom she was very close. The family had a practice of doing things together including purchasing lottery tickets together. Her father contacted the general counsel for the Florida Lottery Commission who advised forming a single entity to claim the prize for the family. The father then called a lawyer who then established an S corporation in which Tonda and her husband would hold 49% of the stock and other family members would have varying percentages of the remaining 51% of the stock in the corporation..

In the interim, four other waitresses at the Waffle House challenged Tonda's right to all of the lottery winnings. They alleged there was an agreement among the waitresses that the waitresses would share whatever lottery winning occurred from tickets that they obtained and, therefore, the other waitresses were entitled to share in 80% of the proceeds. This action was eventually dismissed. In addition, Mr. Seward alleged that he was entitled to part of the lottery winnings. This claim was also dismissed.

The Tax Court found that Tonda had made a gift of the 51% interest in the lottery winnings to the other family members. Tonda's family tried to argue that there was an enforceable agreement among the family to split the proceeds of any lottery winnings.

The court found that there was no evidence of an enforceable contract or partnership to do so among the family members. There was also no evidence that anyone other than the members of the family even knew of the alleged agreement or that any member of the family would have sued Tonda with respect to enforcing the agreement.

The court then determined that if no claims or discounts had occurred, the present value of the ticket proceeds was $4,730,172. It then determined that an appropriate discount for the 80% of the lottery ticket disputed by the four other Waffle House waitresses was 67%. Combining this amount with the 51% of the undisputed 20% that would have gone to Tonda made the total gift by Tonda to her family members worth $1,119,347. The court also allowed a 2% discount for litigation costs.

H. Success in business does not equal to success in estate planning.

Cavallaro v. Commissioner, T.C. Memo 2014-189, affd in part and reversed in part, Nos. 15-1368 (11th Cir. November 18, 2016). Tax Court holds that husband and wife are liable for gift tax following company merger.

In 1979, Mr. and Mrs. Cavallaro started Knight Tool Company. Knight was a contract manufacturing company that made tools and machine parts. In 1982, Mr. Cavallaro and his eldest son developed an automated liquid dispensing machine they called CAM/ALOT. Subsequently, in 1987, Mr. and Mrs. Cavallaro's three sons incorporated Camelot Systems, Inc. which was a business dedicated to the selling of the CAM/ALOT machines made by Knight. The two companies operated out of the same building, shared payroll and accounting services, and collaborated in the further development of the CAM/ALOT product line. Knight funded the operations of both companies and paid the salaries and overhead costs for both.

In 1994, Mr. and Mrs. Cavallaro sought estate planning advice from the accounting firm of Ernst & Young and the law firm of Hale & Dorr. The professionals advised Mr. and Mrs. Cavallaro that the value of CAM/ALOT Technology resided in Camelot (the sons' company) and not in Knight and that they should adjust their estate planning. Mr. and Mrs. Cavallaro and their three sons merged Knight and Camelot in 1995 and Camelot was the surviving entity. Part of the reason for the merger was to qualify for Conformite Europeenne, which means European conformity, so that the CAM/ALOT machines could be sold in Europe. In the 1995 merger, Mrs. Cavallaro received 20 shares, Mr. Cavallaro received 18 shares and 54 shares were distributed to the three sons. In valuing the company, Ernst & Young assumed that the pre-merger Camelot had owned the CAM/ALOT technology. According to the court, Camelot had not owned the CAM/ALOT technology. As a result, the appraiser overstated the relative value of Camelot and understated the relative value of Knight at the time of the merger.

In 1996, Camelot was sold for $57 million in cash with a contingent additional amount of up to $43 million in potential deferred payments based on future profits. No further payments were made after the 1996 sale. The three issues under review by the tax court were:

1. Whether the 19% interest received by Mr. and Mrs. Cavallaro in Camelot Systems, Inc. in exchange for their shares of Knight Tool Company in a tax free merger was full and adequate consideration or was it a gift?

2. Whether Mr. and Mrs. Cavallaro were liable for additions to tax under Section 6651(a)(1) for failure to file gift tax returns for 1995 or was the failure due to reasonable cause.

3. Whether there were underpayments of gift tax attributable to the gift tax valuation understatement for purposes of the accuracy related penalty or whether any portions of the underpayment were attributable to reasonable cause.

With the respect to the valuation issue, the Cavallaros offered two experts with respect to the value of the combined entity. One expert valued the entity between $70 and $75 million and opined that only $13 to $15 million of that value was attributable to Knight. A second appraiser valued the combined entity at $72,800,000.

The IRS retained its own appraiser. This appraiser assumed that Knight owned the CAM/ALOT technology. He valued the combined entities at approximately $64.5 million and found that 65% of that value or $41.9 million was Knight's portion.

In reaching its decision on the gift tax liability, the court noted that the 1995 merger transaction was notably lacking in arm's length character. It also discussed how the law firm in 1995 had tried to document the ownership of the CAM/ALOT Technology by the sons but that such documentation was insufficient. It also thought the accountants had been less than truthful in some of their testimony. It noted that the IRS had conceded during the litigation that the value of the combined entities was not greater than $64.5 million and that the value of the gift made in the merger transaction was not greater than $29.6 million. As a result, the court concluded that Mr. and Mrs. Cavallaro made gifts totaling $29.6 million in 1995.

The court rejected the imposition of penalties for failure to file a gift tax return and accuracy related penalties. It found that in both instances, Mr. and Mrs. Cavallaro had been advised by an accountant or lawyers and that there was reasonable cause for the failure to file a gift tax return and failure to pay the appropriate amount of tax. It noted that Mr. and Mrs. Cavallaro relied on the judgment and advice of the professional advisors and that the CAM/ALOT technology had been owned by the sons' company since 1987 (and thus was not being transferred in 1995). The court went into great detail about Mr. and Mrs. Cavallaro's lack of formal education beyond high school and that they had built the business up themselves in documenting its finding of reasonable cause to avoid the penalties.

This case was appealed on July 6, 2015. The Eleventh Circuit on November 18, 2016 affirmed the Tax Court's decision that the burden of proof was on the taxpayer and its finding that Knight owned the CAM/ALOT related technology at the time of the Knight Camelot merger, but remanded the case to the Tax Court since it also found that the Tax Court misstated the Cavallaros' burden of proof.

I. A revocable GRAT is not a pretty sight.

Letter Ruling 201442042 (October 17, 2014). Modification of a trust to correct scrivener's errors will permit desired tax consequences for grantor retained annuity trust.

An attorney prepared separate four-year and fifteen-year grantor retained annuity trusts ("GRATs") for a client. Under each of the two GRATs, at the end of the applicable annuity term, the property would pass to a Children's Trust for the benefit of the grantor's children. The Children's Trust was drafted as a revocable trust and permitted the grantor to revoke the trust at and to amend or modify the trust at any time.

Subsequently, an accountant was retained by the grantor to prepare the gift tax return to report the transfers to the GRATs. After reviewing the trust documents, the accountant contacted the grantor to express concerns about the retention by the grantor of the right to revoke the trust. The accountant also contacted the attorney who drafted the two GRATs, but the attorney insisted that his drafting of the Children's Trust was proper and noted that the accountant, not being an attorney, did not understand state law governing the trust.

Several years later, a financial planner who reviewed the GRATs concluded that the Children's Trust contained incorrect provisions. The financial planner retained a new attorney to review the trust to also confirm that, for the transfers to the two GRATs to be completed gifts as intended, the grantor should not have the power to revoke the Children's Trust. The second attorney was then retained to reform the Children's Trust under state law. The court allowed the trust to be reformed subject to the issuance by the Internal Revenue Service of a letter ruling stating that the Service would respect the court's retroactive reformation of the Children's Trust for gift tax purposes.

In seeking the ruling, the grantor, the first attorney who drafted the Children's Trust, the accountant, the financial planner, and the second attorney provided affidavits and sufficient evidence that the Service believed constituted clear and convincing evidence that the retention by the grantor of the power to revoke the Children's Trust did not conform to the grantor's intention at the time he created and funded the GRATs for the gifts to the two GRATs to be completed gifts. The Service concluded that state law would permit the reformation of a trust to conform to the grantor's intention if that is proved by clear and convincing evidence that the grantor's intent as expressed in the trust instrument was affected by a mistake of fact or law. As a result, the IRS concluded that, as a result of the reformation, the gifts would be completed and that the distribution of the remainder interests in the GRATs to the Children's Trust would not cause the grantor to make an additional gift. Also, the reformation of the Children's Trust would not cause the assets of the Children's Trust to be included in the gross estate of the grantor if he died after the end of the annuity term of each trust. Finally, the reformation of the Children's Trust would not cause any current or future beneficiary of the trust to make a gift to any other current or future beneficiary of the trust.

J. GRATs must be drafted in accordance with the statute.

Letter Ruling 201652002 (December 23, 2016). Service permits reformation of grantor retained annuity trust to correct scrivener's error.

Grantor retained an attorney to draft several grantor retained annuity trusts (GRATs) over a two year period that began after September 20, 1999. The first page of each grantor retained annuity trust provided that the grantor intended to create a grantor retained annuity trust with a retained annuity that met the requirements of a qualified interest under Section 2702(b)(1). In addition, a later provision of the trust also gave the trustees the power to amend the trust in any manner to ensure that the trust would qualify under Section 2702(b) (1). In drafting each of the grantor retained annuity trusts, the draftsperson failed to include language prohibiting the trustees from issuing a note, other debt instrument, option, or other financial arrangement in satisfaction of an annuity obligation as required by Treas. Reg. § 25.27023(d)(6).

Grantor was made aware of this failure when the grantor's son retained a new attorney to review the grantor's estate plan. As a result of that review, the trustees filed an action in court seeking reformation of each of the GRATs to correct the scrivener's error. The court issued an order reforming each trust to include the language required by the Treasury Regulations. Grantor requested a ruling from the Service that as a result of the judicial reformation of the GRATs to correct the scrivener's error, Grantor's retained annuity interest in each GRAT was a qualified interest effective as of the date that each grantor retained annuity trust was established. The IRS in reviewing the facts and noting that each GRAT provided that the grantor's retained interest was intended to be a qualified interest under Section 2702, and the fact that the trust instrument and state law permitted the amendment of each trust, ruled that, as a result of judicial reformation of each GRAT to correct the scrivener's error, the grantor's interest in each trust would be a qualified interest as of the date on which each grantor retained annuity trust was created.

K. The term of a GRAT cannot be shortened, no matter what the cost.

Badgley v. United States, _____ F.Supp.3d _____ (N.D. Cal 2018). The assets of a GRAT are included in the settlor's estate

In 1998, Patricia Yoeder created a grantor retained annuity trust. Patricia was to receive annual annuity payments for the lesser of fifteen years or her prior death in the amount of 12.5 percent of the date of gift value of the property transferred to the GRAT. The GRAT paid Patricia an annuity of $302,259. Upon the end of the annuity term, the property was to pass to Patricia's two living daughters. The GRAT also stated that, if the trustor failed to survive the trust term, the trustee was to pay all the remaining annuity amounts and the portion of the trust included in the trustor's estate to the survivor's trust created under Patricia's revocable trust.

Patricia died on November 2, 2012 having received her last annuity payment from the GRAT on September 30, 2012.

The federal estate tax return reported a gross estate of $36,829,057, including the value of the assets held in the GRAT. The estate paid federal estate taxes of $11,187,457. On May 16, 2016 the estate filed a claim of refund seeking $3,810,004 in estate tax overpaid by the estate as a result of the inclusion of the full value of the GRAT. The case was before the court on cross-motions for summary judgment from the government and the estate.

The estate moved for summary judgment on two bases, asserting that Section 2036(a)(1) did not apply to Patricia's GRAT and that Treas. Reg. § 20.2036-1(c)(2) was overly broad and invalid to the extent that it applied to the GRAT and the transfer of property to the net of the bona fide sale for full and adequate consideration expenses to Section 2036. The government moved for summary judgment on the opposite grounds. The estate argued that a "fixed-term annuity" was not the same as a right to income or some other form of possession or enjoyment as required by Section 2036(a)(1). However, the government relied on three cases that took a broad approach to the operative language of Section 2036 and its predecessor: C. I. R. v. Church's Estate; 335 U.S. 632 (1939); Spiegel's Estate v. Commissioner, 335 U.S. 701 (1949); and Helvering v. Hallock, 309 U.S. 106 (1940). The court found that Section 2036 applied to the GRAT. Although plaintiff was correct that the government's authorities did not expressly equate a fixed-term annuity with a right to income or some other possession or enjoyment, the Supreme Court had adopted a substance over form approach that favored a finding that the annuity comprised some form of possession, enjoyment, or right to income from the transferred property.

Treas. Reg. 20.2036-1(c)(2)(i) requires that transferred GRAT property be included in a decedent's gross estate where the decedent retains an annuity interest and dies before the expiration of the annuity term. The court found that the regulation was valid even though Section 2036 does not equate "income" with a fixed term annuity in Section 2036. The silence did not mean that the interpretation of the Section is arbitrary or capricious. Instead the regulation is a permissible interpretation of Section 2036. The court also rejected the argument that the regulation was arbitrary because it would result in the inclusion of all private annuities in the decedent's gross estate and was overly broad to the extent that the regulations subsequently included GRATs such as Patricia's that "have no ordering rule, do not provide for income payments disguised as annuity payments, and at the time of grantor's death can satisfy the annuity payments entirely out of principal." The second argument failed once the court rejected the attempted distinction between an annuity and a right to income.

The court also rejected the argument that the creation of the GRAT was property transferred to the GRAT in a bona fide sale in exchange for an annuity. The court noted that the funding of the GRAT does not involve selling the transferred property to a third party in exchange for an annuity. There is no other owner of property engaging in the sale transaction other than the transferor.

Finally, the formula used to determine the included value of the GRAT was reasonable even though it assumed that the annuity was paid solely from income. The estate argued

that an annuity can, in fact, be paid from either principal or income and thus the formula yielded a capriciously large amount to be included for tax.

As a result, Patricia's GRAT was properly included in calculating the value of her gross estate.

III. Charitable Gifts

A. It's not charitable if it's all in the family.

Letter Ruling 9631004 (April 30, 1996). IRS disallows charitable deduction for scholarship fund limited to recipients with the same surname of the decedent.

The question of whether a "charitable" trust or gift benefits a broad enough class of individuals to be considered a deductible charitable transfer has been litigated frequently. The issue often arises in connection with scholarship funds. Several cases have held that a trust which limits scholarships to a limited class of individuals bearing the family surname is a "private trust" that will not qualify for the gift tax or estate tax charitable deduction. See, e.g., Davis v. Comm'r, 55 T.C. 416 (1970); Estate of Dorsey v. Comm'r, 19 T.C. 493 (1952). Conversely, cases have held that if the surname provision merely states the decedent's preference for individuals sharing the same surname and allows the trustee to select other scholarship recipients, then a charitable deduction will be allowed for the trust. See Estate of Sells v. Comm'r, 10 T.C. 691 (1948); Commonwealth Trust Co. of Pittsburgh v. Granger, 57 F. SUPP. 502 (W.D. Pa. 1944).

The IRS applied this case law in Letter Ruling 9631004. The IRS determined that the trust in question was a private trust because it limited the class of persons eligible as scholarship recipients to individuals with the same surname of the decedent, the family name was the surname of only 603 families in the United States, and the trustee was limited to distributing trust funds to only two universities in the same city as the decedent's residence.

The IRS added that a trust deemed to be private trust cannot avail itself of the cy pres doctrine to change the terms of the trust. The cy pres doctrine may be invoked by a court to deviate from the trust's original purpose or purposes and modify the trust provisions to apply the trust funds as closely to the settlor's plan as possible. However, the cy pres doctrine applies only to charitable trusts and not to private trusts and thus cannot be used to turn a private trust into a charitable trust.

Theoretically, a taxpayer could place a surname requirement on a scholarship program if the name is extremely common; for example, Smith or Jones. However, the safer route is to make the provision precatory, and allow the trustee also to select recipients without the family surname. Other viable options also may be available. In Estate of Sells v. Comm'r, 10 T.C. 691 (1948), the court approved charitable status for a trust which

permitted the trustee to choose scholarship recipients not bearing the family name only after a determination that there were no eligible individuals with the surname.

<u>Gust Kalapodis v. Commissioner</u>, T.C. Memo 2014-205. Tax court concludes that taxpayers are not entitled to an income tax charitable contribution deduction for scholarship payments made by irrevocable trust created in memory of deceased son.

In 2006, Mr. and Mrs. Kalapodis received $75,000 in life insurance proceeds as a result of the death of their son. That same year, the Kalapodises used the life insurance proceeds to establish a memorial scholarship fund in honor of their son. The scholarship fund was structured as an irrevocable trust. The trust agreement stated that the income from the trust is to be used exclusively for educational purposes. The trust did not apply for tax-exempt status as a charitable organization. During 2008, the trust made payments of $2000 each to three high school students. Each payment was made by check directly to the student from an account owned solely in the name of the trust.

When the Kalapodises filed their 2008 individual income tax return, they did not include the investment income from the trust in their gross income; however, they claimed a $6,000 charitable income tax deduction for the payments made to the students. The IRS disallowed the charitable income tax deduction claimed by the Kalapodises.

The Tax Court held that the Kalapodises were not entitled to the $6,000 income tax charitable contribution for three reasons. First, an irrevocable trust and not the Kalapodises paid the money out as scholarships. No provision of the trust agreement would permit the Kalapodises to report the tax attributes of the trust on their personal income tax return. Second, even if the Kalapodises could report the tax attributes of the irrevocable trust on their personal return, the trust payments did not qualify as charitable contributions. Section 170(c) has specific rules for who are permissible recipients of a contribution or a gift in order for the payment to qualify as a charitable contribution for which an income tax charitable deduction is permitted. Students did not fall into any of the permissible categories of recipients. Finally, the Kalapodises failed to produce any evidence of a contemporaneous written acknowledgement of the charitable contribution since the amount was over $250 as required by Section 170(f)(8)(A).

Letter Ruling 201334043 (August 23, 2013). Trust established to support widow and her children is not entitled to tax exempt status because it operates for the private benefit of the designated individuals.

A trust was formed for the benefit of a widow and her unmarried children for the health, education and support of the widow and her unmarried children to the extent that they could not earn sufficient income from gainful employment and other business endeavors. The trust was to operate in a manner to qualify as an exempt organization under Section 501(c)(3). The trust was referred to as a foundation.

During the exemption application process, the trust modified its activities to provide assistance to the family of the widow and to other families in similar situations. In a final amendment, the reference to the widow was removed from the purpose clause. Instead

the purpose stated that the trust was formed for the benefit of any Jewish family where a parent died in a fatal accident. According to the IRS, this amendment was not signed and there was no evidence that the amendment was adopted.

The IRS found that the trust met neither the organization test nor the operational test. It failed the operational test because it was not organized exclusively for charitable purposes. It failed the operational test because it more than substantially benefited the widow and her family.

B. If the question is "How much was left to charity?" The correct answer is not "I'm not sure."

Marine Estate v. Comm'r, 990 F.2d 136 (4th Cir. March 30, 1993) (affirming 97 T.C. 368 (1991)). Charitable deduction denied because amount was unascertainable.

In this case, a charitable deduction was denied for residuary gifts left to two universities because the amount of the gifts were rendered unascertainable by provisions in the decedent's will that gave his personal representatives discretion to make bequests to "persons who had contributed to his well-being during his lifetime."

One of the requirements for the charitable deduction under Code Section 2055 is that the amount that the charity will receive must be ascertainable at *the decedent's death*. In this case, the decedent caused the residuary bequests under his will to be unascertainable when he executed a codicil giving his personal representatives sole and absolute discretion to make specific bequests of up to one percent of the decedent's gross estate to one or more persons who had misted the decedent during his life. There was no limit on the number of bequests that the personal representatives could make, so the bequests conceivably could have consumed the decedent's entire estate. As a result, the estate was denied a charitable deduction that would have exceeded over $24 million, even though the personal representatives actually made only two bequests under the codicil totaling $25,000.

The personal representatives argued that the charitable gifts were rendered ascertainable when the personal representatives obtained a court order approving payment of bequests to the two individuals and closing the class of beneficiaries who could be named. The IRS rejected this argument because the court order was not issued until nearly two years after the decedent's death.

Clearly, the best way to avoid this problem would have been for the decedent to identify the specific bequests he wished to make rather than leaving discretion to the personal representatives. It also may have been possible for the personal representatives to preserve the charitable deduction by disclaiming this power to make specific bequests before the filing of the federal estate tax return. See, e.g. Letter Ruling 9151012 (September 19, 1991). In order to do so, however, it appears that the personal representatives would have had to decline to exercise the power at all. Any exercise of

the power would prevent the disclaimer from being qualified under Sections 2055(a) and 2518.

C. Do you want one charitable deduction benefit or two?

<u>Ferguson v. Comm'r.</u>, 83 AFTR 2d ¶99-648 (9th Cir. 1999). Court imputes gain to donor for gift of appreciated stock shortly before the sale of a closely-held company.

A gift of appreciated stock to charity before a sale of the underlying company can produce an income tax charitable deduction for the full value of the stock and avoid the income tax on the unrealized appreciation in the stock. However, the gift to charity must occur before the donor is bound by the sales transaction. If the donor is committed to the sale, he or she still will receive a charitable income tax deduction, but the donor will be treated as having sold the stock before donating, and will have to recognize the capital gain on the unrealized appreciation.

In this case, the donors, members of the Ferguson family, owned stock in American Health Companies, Inc. The Ferguson family had founded the business many years ago and had taken the business public in 1986. In May 1988, the company hired an investment banker to search for a purchaser, and, as a result, on August 3, 1988, a third party made a tender offer of $22.50 a share to accomplish a merger. The acquiring entity announced on September 12, 1988 that the necessary 85% of the company's stock had been tendered and that it accepted all tendered stock. The final steps in the acquisition were consummated on October 14, 1988.

The Fergusons on August 15 and 16 notified the Mormon Church that they were donating a significant number of shares of the company to it. In addition, on August 26, the Fergusons organized two private foundations to which shares of stock would be donated.

The shares to be donated to both the church and the private foundations were deposited in new brokerage accounts in the donor's names on August 16th and August 23rd. On September 8th, under an in-house entry by the broker, the stock was transferred from the new accounts to the accounts of the Morman Church and the two private foundations. The corporate secretary of the company reported the change in the ownership of the stock to the Securities and Exchange Commission on September 9, 1988.

The IRS argued that the stock "ripened" from an interest in a viable corporation into a fixed right-to-receive cash by the time of the August 3, 1988 tender offer. Thus, the Fergusons needed to make the gifts before August 3, to avoid recognizing the capital gain on the stock. The donors argued that the right to receive proceeds did not "ripen" until October 12, 1988 when the final steps were taken to implement the acquisition of the company.

The court applied a constructive receipt approach under which it analyzed when that point of certainty in the stock transaction was reached to ensure completion of the merger. The Tax Court had concluded that the tender or guarantee of more than 50% of the outstanding shares was the functional equivalent to a vote by the shareholders

approving the merger. The Ninth Circuit agreed and concluded that the stock ripened from an interest in a viable corporation into a fixed right to receive cash by August 31, 1988. Since the beneficial ownership of the donated stock was not transferred until September 8 or 9, the stock still belonged to the Fergusons as of the date of ripening and they had to recognize capital gain.

One problem here, unlike many other similar transactions, is that the stock was publicly traded. Numerous hurdles must be cleared when control persons, such as the donors, make contributions of stock subject to restrictions under the securities laws. For example, in this case, the broker's legal department had to approve the transfer, which caused a delay in completing the transfer. This case serves as a reminder that, when making gifts of appreciated stock to a charity before a contemplated merger or sale, the gifts should be completed as soon as possible to prevent the making of any sort of a ripening argument.

D. A trust for both charities and individuals is not for amateurs.

Zabel v. United States, 995 F. Supp. 1036 (D. Nebraska 1998). Estate tax charitable deduction denied for a decedent's estate because a testamentary split interest trust failed to meet the requirements for a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund.

Decedent's residue, which was worth approximately $1.8 million, was bequeathed to a testamentary trust. Fifty percent of the net trust income was to be distributed to two relatives until the first to occur of their death or 21 years and the balance of the trust income was to be distributed to two charities. The charities were also named as the remainder beneficiaries. The court found that the trust was not entitled to a charitable deduction under Section 2055. In order for a split interest trust to qualify for the estate tax charitable deduction, the trust or gift must be in the form of a charitable annuity trust, a charitable unitrust, or a pooled income fund. This trust complied with none of those requirements.

Letter Ruling 201004022 (January 29, 2010). IRS rules that estate is not entitled to charitable deduction for amount paid to charity pursuant to a settlement agreement.

Upon decedent's death, it was determined that the decedent's will, as amended by three codicils, lack a residuary provision. The will first provided for the payment of taxes and expenses out of the residuary. It next established a charitable trust. The decedent next devised real property to be held in trust for the use of his Son and Son's wife during their lifetimes. Upon the death of the second to die of Son and Son's wife, the real property was to be sold and the proceeds added to the charitable trust. Then, the decedent bequeathed a specific amount in trust for the benefit of Son under which the Son received mandatory income payments and principal could be invaded to pay for medical expenses. If Son's wife survived, the income was to be paid to Son's wife. Upon the second death, the remaining property was to be paid to the charitable trust. Trusts similar to the one for Son and Son's wife were created with gifts of specific amounts for the benefit of other relatives.

Son claimed that as decedent's sole intestate heir, he was entitled to the residuary estate. The charitable trust claimed that it was the lawful beneficiary of the residuary estate and that the omitted residuary clause was the result of a drafting error. The attorney who drafted the will and the codicils stated in an affidavit that the decedent told him that he intended for the residue to pass to the charitable trust.

Son and the charitable trust settled the dispute through a settlement agreement under which Son received a specific sum outright and free and clear of all expenses and taxes. The amount remaining after the outright payment to Son and after the payment of expenses and taxes (including the taxes on the distribution of the specific amount to Son) was to be paid to the charitable trust. The settlement agreement was approved by a local court without an evidentiary hearing.

The IRS ruled that the amount passing to the charitable trust did not qualify for the estate tax deduction since the property did not pass to the charitable trust. The Service looked at Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981), which determined that an amount received by a surviving spouse pursuant to a lower state court judgment is treated as passing for federal estate purposes (and thereby qualifying for the marital deduction) if "the interest reaches the spouse pursuant to state law, correctly interpreted—not whether it reached the spouse as a result of a good faith adversary confrontation." A good faith settlement or judgment of a lower state court must be based on an enforceable right under state law properly interpreted to qualify as "passing" for purposes of the estate tax marital deduction.

The IRS used the Ahmanson test for "passing" to qualify for the marital deduction in this ruling to see if the property "passed" to the charitable trust and would qualify for the charitable deduction. It determined that the charitable trust did not have an enforceable right under the governing law to the settlement proceeds in this case. It noted that the governing law provided that a testator who executed a will is presumed to intend to dispose of his entire estate and avoid intestacy. However, such a presumption is met by an equal presumption that an heir is not to be disinherited except by plain words or necessary implication. The extrinsic evidence, including the attorney's affidavit, indicated that the residuary clause was erroneously omitted, and failed to create an ambiguity. The son was entitled to receive the residuary as the sole heir of decedent. Since the charitable trust did not have an enforceable right, the amount it received as the result of the settlement agreement failed to qualify for the estate tax charitable deduction.

E. You must observe the formalities with charitable remainder trusts or else the remainder will be a dead end.

Atkinson v. Commissioner, 309 F.3d 1290 (11th Cir. 2002). Trust not administered as a charitable remainder annuity trust, so charitable deduction denied.

Most trusts that fail to qualify as charitable remainder trusts do so because of deficiencies in their terms. As drafted, the trust in the case satisfied all the necessary requirements. However, as implemented and administered, it did not qualify. In 1991, Melvine B. Atkinson placed approximately $4 million in the Melvine B. Atkinson Charitable

Remainder Annuity Trust. The trust provided that Atkinson would receive a 5% annuity during life. Upon his death, the 5% annuity was to continue for various individuals, but only if each individual furnished his or her share of the federal and state death taxes that might be owed because of the inclusion of the charitable remainder annuity trust in Atkinson's estate. During Atkinson's life, none of the required quarterly payments were made to him from the charitable remainder annuity trust. Atkinson died in 1993. Upon his death, only one of the secondary beneficiaries of the charitable remainder annuity trust elected to take her share. However, this individual informed the trustee that Atkinson had indicated that she would not be liable for her share of the estate taxes and she had a notarized document from Atkinson to that effect. Her claims were settled by obtaining an order for the payment of any estate taxes out of a separate irrevocable trust Atkinson had created. It later turned out that the assets in the irrevocable trust were insufficient to pay the death taxes and the charitable remainder annuity trust had to be invaded to pay those taxes.

The court first found that although the charitable remainder annuity trust met the letter of the statutory requirements, the trust was not managed in accordance with its terms. For example, as noted above, none of the requested annuity payments were made. The executor argued that checks were remitted to Atkinson, but were not cashed. However, no canceled or uncancelled checks were presented to the court nor did the executor present any evidence demonstrating a gap in the checks' sequence. In addition, the charitable remainder annuity trust failed to qualify because estate taxes were paid from the trust. See Revenue Ruling 82-128, 1982-2 C.B. 71.

CCA 200628028 (July 14, 2006). Sloppy administration of charitable remainder trust results in disqualification of trust.

The IRS was asked to examine a trust to determine if it was a charitable remainder unitrust in this Chief Counsel's Advisory Opinion. Under Section 664(d)(2), a charitable remainder trust is a trust in which a fixed percentage (not less than five percent nor more than 50 percent) of the net fair market value of its assets valued annually is paid to one or more private individuals.

One basic requirement of a charitable remainder unitrust is that no amount other than the unitrust amount can be paid to or for the use of a private individual. Section 664(d)(1)(D). Under the facts submitted here, the grantor, A, as trustee had written checks from the trust checking account to himself, his wife, and third parties on a random basis and essentially treated the account as a personal bank account. One example was the payment of monthly installment payments on a pickup truck that A owned personally for two years. The trust had also allowed A to use real estate held by the trust rent free. In addition, the trust prepaid A's rent for 10 years in a building owned by a third party.

Because of these flagrant abuses, the IRS held that the trust was not a charitable remainder trust. Instead, the trust was a grantor trust for income tax purposes and A was to be treated as the owner of the trust under Section 677.

<u>Estate of Jackson v. United States</u>, 408 F.Supp. 2d 209 (N.D. W.Va. 2005). Testamentary split interest trust qualifies for estate tax charitable deduction even though it is not a charitable remainder trust.

Decedent's trust provided that after his death, income would be payable to a nephew and three nieces. Upon the death of each, ¼ of the trust corpus was to pass to a charity. This trust did not qualify as the charitable remainder trust because it paid neither an annuity nor a unitrust amount to the nephew or the nieces.

When the decedent died on November 28, 1999, the attorney for the trust became concerned about possible conflicts of interest and the dissatisfaction of the beneficiaries at being limited to income. To resolve the problem, the trustee and the beneficiaries agreed to terminate the trust and to distribute the actuarial value of their respective interests to the income beneficiaries and the charity. $229,000 was distributed to the charity as its share. The estate deducted this amount on the estate tax return as a charitable deduction. As one might expect, the IRS denied the deduction.

The parties agreed that the trust was not a valid split interest trust and that it had not been reformed as permitted under Section 2055(e)(3). However, the court used a policy argument to grant the estate tax charitable deduction. It found that the goal of the statute was to ensure that the charitable deduction equals the value received by the charity. Here, because the charity received the amount to which it was entitled, there was no reason to deny the charitable deduction. The court rejected the government's assertion that Section 2055(e)(3) is only applicable where the non-deductible split interest is terminated in the settlement of a will or to avoid an imminent breach of fiduciary duty. The court also noted that neither the trustees nor the beneficiaries were aware of the requirements of Section 2055(e) for reforming a trust.

<u>Galloway v. United States</u>, No. 05-50 (W.D. Pa. May 9, 2006). Testamentary trust failed to qualify as charitable remainder trust and estate tax charitable deduction was denied.

When James Galloway died on July 22, 1998, his revocable living trust provided for the residue of his estate to pass in four equal shares to his granddaughters and two charities. The trust provided for distributions to each of the four beneficiaries on two separate dates. Each of the residual beneficiaries received fifty percent of their total expectancy in early 2006. The remaining corpus of the trust was to be paid to the beneficiaries in four equal shares in 2016 and the trust would then terminate.

On the federal estate tax return, the trust claimed an estate tax charitable deduction of $399,079.33 for the portion of the corpus that the trustee anticipated would ultimately pass to the charities. On audit, the IRS denied the deduction. The IRS stated the trust was a "split interest trust" in that it divided the same property between charitable and non charitable entities. Because the trust did not qualify as a charitable remainder trust under Section 2055(e)(2), the IRS assessed an additional $160,394.13 in federal estate tax. The estate paid the tax and brought suit in federal district court for a refund.

The Court first noted that Section 2055(e)(2) permits a split interest trust to receive an estate tax charitable deduction only if the trust is a charitable remainder trust, a charitable lead trust, or a pooled income fund. The government contented that this case involved a classic split interest where an interest in the same property passed to both charitable and non charitable beneficiaries. The taxpayer argued that Section 2055(e) did not apply to the Galloway trust because the trust did not split interests in the same property. Instead, the trust for all intents and purposes was two separate trusts.

The Court then looked at the Zabel v. United States, 995 F.Supp. 1036 (D. Nev. 1998) where the income generated by the trust was to be split between charitable and individual beneficiaries for 21 years with the remaining corpus to be distributed to the charitable beneficiaries at the expiration of the 21 year period. The Zabel court had denied a charitable deduction, even though separate accounts were maintained for the charitable and individual beneficiaries. This was because the language of the Zabel trust failed to create a split interest trust as defined by Section 2055. The Court noted that a similar result was reached in Estate of Edgar v. Commissioner, 74 TC 983 (1989), aff'd., 676 F.2d 685 (3rd Cir. 1982). The court felt that, as in Zabel and Edgar, the Galloway trust split a single estate between charitable and non-charitable interests. Since the trust was a split interest trust and did not meet the statutory requirements for a charitable remainder trust, charitable lead trust or pooled income fund, the charitable deduction was denied.

Tamulis v. Commissioner, 509 F.3d 343 (7th Cir. 2007). Trust is not to be treated as charitable remainder trust and estate tax charitable deduction is denied.

A Catholic priest died in 2000 leaving an estate of $3.4 million. The bulk of his estate was left in a trust that was to continue for the longer of ten years or the joint lives of the priest's brother and the brother's wife. During that period, they would have a life estate in a house owned by the trust and the trust would pay the real estate taxes on the house. The net income of the trust was to go to two of the priest's nieces, less $10,000 annual payments to a third niece until the third niece graduated from medical school. Upon the termination of the trust at the end of the ten year term, the assets would pass to a downstate Illinois Catholic Diocese.

On the federal estate tax return, a $1.5 million charitable estate tax deduction was claimed for the present value of the charitable remainder, which was described as "the residue following ten year term certain charitable remainder unitrust at 5% quarterly payments to the grandnieces."

The trustee/executor and the diocese realized that the trust as written did not qualify as a charitable remainder trust. However, more than eight months after the priest's death elapsed before the executor prepared a complaint to file in an Illinois state court to start a reformation action. For some reason, the complaint was never filed. Instead, the executor circulated to the income beneficiaries a proposed reformation of the trust to make it a valid charitable remainder trust. Two of the three nieces signed on to the proposed reformation, but the third did not. Illinois law required the consent of all the beneficiaries for a reformation to qualify the trust as a charitable remainder trust. As a result, the trust was never reformed, although the trustee administered it in accordance

with the requirements of the Internal Revenue Code for a charitable remainder trust. The estate argued that the trustee's continued administration of the trust as if it were a qualified charitable remainder trust should be deemed substantial compliance even though there was not literal compliance.

The Seventh Circuit rejected any attempt to apply a doctrine of substantial compliance to permit the estate tax charitable deduction. It found that the doctrine of substantial compliance should only apply to cases in which the taxpayer had a good excuse (though not a legal justification) for failing to comply with either an unimportant requirement or one unclearly or confusingly restated in the statute or regulations. This charitable remainder trust flunked the test. The executor/trustee was represented by counsel and was aware that a substantial estate tax deduction was at stake. The executor/trustee had no excuse for failing to bring the required judicial proceeding to reform the trust. It found that the requirements for a reformation were neither unimportant nor were they stated unclearly or confusingly in either the Internal Revenue Code or regulations.

Moreover, the inability under Illinois law to have a reformation of the priest's trust without the consent of all the beneficiaries was not a reason to reverse the result. Therefore the doctrine of substantial compliance could not be used to excuse the failure to comply with those rules.

<u>Mohamed v. Commissioner</u>, T.C. Memo 2012-152. Tax Court denies income tax charitable deduction for property donated to a charitable remainder unitrust.

Joseph and Shirley Mohamed donated real estate to a charitable remainder unitrust in 2003 and 2004 but failed to follow the requirements for documenting the donations. In 2003, the Mohameds donated five properties worth millions of dollars to the charitable remainder trust. Joseph Mohamed completed the 2003 federal income tax return and admitted that he did not read the instructions before completing the return. Mohamed used his own appraisals of the parcels rather than engaging an independent appraiser to do a qualified appraisal. He did not report the basis in the donated properties and he did not attach an appraisal summary to the income tax return. In 2004, the Mohameds donated a shopping center to the charitable remainder unitrust and again Mohamed performed the appraisal of the shopping center for purposes of the income tax charitable deduction and failed to attach an appraisal summary to the income tax return.

The government moved for summary judgment to deny any charitable income tax deductions. Although the court obviously felt that this was a harsh result, it granted summary judgment because the Mohameds failed to follow the rules in the regulations requiring a qualified appraisal performed by an independent appraiser and an appraisal summary to be attached to the income tax return for the charitable deduction. The court also upheld the regulations and rejected the Mohameds' argument that they had substantially complied with the regulations. It noted that there was a line of reasoning that a taxpayer cannot substantially comply if the taxpayer fails to comply with an "essential requirement" of the governing statute. The failure to obtain a qualified appraisal could not be excused since it is an essential requirement. As a result, the income tax charitable deduction was denied.

<u>Estate of Dieringer v. Commissioner</u>, 146 T.C. No. 8 (2016). Estate tax charitable deduction limited by post-death events.

Decedent and family members owned DPI, a closely held real property management corporation. Decedent was the majority shareholder to DPI and owned 425 of the 525 voting shares and 7,736.5 of the 9,920.5 non-voting shares. While she was alive, decedent established a revocable trust and a foundation. Her son was the sole trustee of both the trust and the foundation. Decedent's will left her entire estate to the trust. Pursuant to the terms of the trust, $600,000 was to pass to various charities and decedent's children received minor amounts of her personal effects. The remainder of the estate, which would consist primarily of the DPI stock, was to be distributed to the acting trustee of the foundation. An appraisal determined the date of the death value of decedent's DPI non-voting and voting shares at $14,182,471. The voting stock was valued at $1,824 per share with no discount and the non-voting stock was valued at $1,733 per share which included a 5% discount to reflect the lack of the voting power. Numerous events occurred after decedent's death, but before decedent's property was transferred to the foundation. Seven months after decedent's death, DPI elected S-corporation status. DPI also agreed to redeem all of decedent's shares from the trust. DPI and the trust amended and modified the redemption agreement. DPI agreed to redeem all 425 of the voting shares and 5,600.5 of the 7,736.5 non-voting shares. In exchange for the redemption, the trust received a short-term promissory note for $2,250,000 and a long term promissory note for $2,968,462. At the same time, three of these of decedent's sons purchased additional shares in DPI. The foundation later reported that it had received three non-cash contributions consisting of the short-term and long-term promissory notes and non-voting DPI shares. The total value of the two promissory notes was $5,218,462.

An appraisal of decedent's DPI stock for purposes of the redemption and subscription agreements determined that the voting shares had a fair market value of $916 per share and non-voting shares had a fair market value of $870 per share. The value of the DPI stock reported as received by the foundation from the trust was $1,858,961. The appraisal of the voting stock included discounts of 15% for lack of control and 35% for lack of marketability. The appraisal of the non-voting stock included the lack of control and marketability discounts plus an additional 5% discount for the lack of voting power at shareholder meetings.

On the federal and state estate tax returns, the estate reported no estate tax liability and claimed an estate tax charitable deduction of $18,812,181 which included the date of death value of decedent's DPI shares. The estate argued that the charitable deduction should not depend upon or be measured by the value received by the foundation. The IRS argued that the amount of the charitable contribution should be determined by post-death events.

The IRS agreed that normally that the value of the estate tax charitable deduction is to be determined as of the moment of death and also agreed that the estate did not elect alternate valuation under Section 2032. It did argue that there are circumstances where the appropriate amount of a charitable contribution deduction does not equal the date of

death value of the contributed property, citing Ahmanson Foundation v. US, 674 F.2d. 761 (9th Cir. 1981).

The court agreed with the IRS and found that the value of the charitable contribution to the foundation was less than the date of death market value of bequeathed property because numerous events occurred after decedent's death that changed the nature of and reduced the value of the property actually transferred to the foundation and held that the estate was liable for an accuracy related penalty. The amount of additional estate tax owed was $4,124,717 and the accuracy related penalty was $824,943.

The court noted that the same appraiser valued the DPI stock for purposes of determining the date of death value of the property as well as the value for purposes of the redemption. The appraiser testified that for purposes of the redemption, he was specifically instructed to value that DPI stock as a minority interest. The court found that the brothers had thwarted decedent's testamentary plan by altering the date of death value of decedent's intended donation through a redemption of a majority interest as minority interest. It cited Treas. Reg. § 20.2055-2(b)(1) to the effect that if a trustee "is empowered to divert the property… to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed...the deduction will be limited to the portion, if any, of the property or fund which is exempt from an exercise of the power."

F. Getting cute with the charitable deduction does not pay.

Technical Advice Memorandum 200341002 (October 10, 2003). Taxpayer not allowed either charitable deduction or annual exclusion for gifts to trust subject to Crummey Powers in charities.

This ruling reviewed the effect of Crummey powers of withdrawal given to four charities with respect to gifts to an irrevocable trust. It appears that the taxpayer was attempting to use the charities to transfer additional property into the trust tax-free. It also seemed, however, that the taxpayer actually may have intended to benefit the charities.

The trust in question provided that distributions could be made to the trust beneficiaries in the trustee's discretion. The designated beneficiaries were two children of the grantor, one child's spouse, and four named charities. Upon the death of the grantor any remaining trust property was to be distributed 60% to the individual beneficiaries, 25% to one charity, and 5% each to the remaining three charities. The trust also granted the beneficiaries powers of withdrawal over contributions to the trust in the percentages indicated, not to exceed $10,000 per beneficiary per annual contribution. None of the charities ever exercised their withdrawal rights.

On his gift tax return, the grantor characterized the transfers to the trust, which were subject to the charities' withdrawal rights as present interest gifts, which qualified for the charitable deduction. The IRS denied both the charitable deduction and the annual exclusion. It concluded that the transfers did not qualify for the charitable deduction under Section 2522 because none of the charities exercised a withdrawal power and

therefore no property actually passed to charity in connection with the gifts. The IRS noted that, other than by virtue of the Crummey powers, there was no guarantee the charities would receive anything because of the trustee's discretionary distribution powers during the term of the trust. The IRS cited Commissioner v. Estate of Sternberger, 348 U.S. 187 (1955), for the proposition that there is no statutory authority for a gift tax charitable deduction where there is no assurance that the charity ever will receive a specific amount.

The ability of the trustee to divert all the assets to individual beneficiaries also was the critical factor in leading the IRS to determine that no annual exclusion was available. The IRS stated that, in light of the fiduciary obligations of the officers and directors of a charity to protect and preserve the charity's property and property rights, no charity would decline to exercise a withdrawal right unless there was certainty that it would recoup the property later. Since there was no certainty in this case, the IRS concluded that there must have been an unwritten "impediment" to exercising the withdrawal rights.

G. Retention of too much control may be bad.

Letter Ruling 200328030 (July 11, 2003). Grantor's retained power to change beneficiaries of charitable lead unitrust disqualifies the trust.

In a charitable lead trust, the charitable beneficiaries receive a stated amount each year for a specified term of years or the life or lives of an individual or individuals. At the end of the period, the remaining corpus is distributed to or in trust for the grantor's descendants or other non-charitable beneficiaries. A charitable lead trust enables a person to satisfy current charitable intentions and, at the same time, transfer significant amounts of property to private beneficiaries at a reduced transfer tax cost.

A charitable lead trust is very flexible and can be set up as either an annuity trust or a unitrust. It may allow the trustee to determine which charities will receive payments or it can provide for specific charities. Unlike a charitable remainder trust, there is no minimum payout for a charitable lead trust and it can be for any term of years. In creating a charitable lead trust, a grantor makes a charitable gift of the present value of the charities' right to receive payments. This gift qualifies for the federal gift tax charitable deduction. The grantor also makes a taxable gift of the remainder, which is often offset by the grantor's $1 million gift tax applicable exclusion amount.

In this ruling, a grantor proposed to create a charitable lead unitrust under which the trustee would pay a private foundation a 5% unitrust amount for a 20-year period. The grantor retained the power to remove the current charitable beneficiary, add or substitute other charities, and change the shares of any one or more charities.

The IRS pointed out that the grantor's retained power to change the charitable beneficiaries made the transfer incomplete for gift tax purposes under Section 2511. The IRS cited to Revenue Ruling 77-275 1977-2 CB 346, under which a retained power to designate charitable beneficiaries of a trust renders a transfer to a charity incomplete for gift tax purposes. In addition, upon the grantor's death before the end of the charitable

term, the retained right to designate the charities would be considered a retained power to control the enjoyment of the property under Section 2036(a)(2) and the assets of the charitable lead trust would be fully includable in the settler's gross estate.

As the ruling indicates, the grantor's retained power to change the charitable beneficiaries disqualifies a charitable lead trust. It is possible, however, to grant other individuals (including a spouse or child) the power to designate or change the charitable beneficiaries.

Letter Rulings 201421023 and 201421024 (May 23, 2014). IRS concludes that annuity payments from charitable lead annuity trusts pursuant to the terms of previously executed charitable pledge agreements will not constitute self-dealing.

Revocable living trusts created by each of Husband and Wife provided for testamentary Charitable Lead Annuity Trusts ("CLATS") to be created and funded at each settlor's death to satisfy the terms of previously executed, but still outstanding, charitable pledge agreements. The annuity payments from the CLATs were to be paid to a private foundation of which Husband and Wife were trustees. After the ruling request was submitted, Husband passed away.

One charitable pledge arose because various members of Husband and Wife's extended family agreed to donate money to support the creation of a new hospital foundation. Under the funding agreement for the hospital foundation, Husband and Wife's foundation was to donate a specific sum in ten equal installments. In addition, Husband agreed to contribute an additional amount under the agreement by funding the CLAT either during life or at death. For the second pledge, Husband and Wife caused the co-trustees of their private foundation to agree to donate certain sums to a museum. Wife, as trustee of her revocable trust, also agreed to donate certain funds to a museum. Part of this funding was to come through a testamentary CLAT to be created upon Wife's death.

The IRS first determined that Husband and Wife were disqualified persons with regard to both the foundation and the CLATs. In order to avoid any self-dealing, there would have to be a determination that the specified payments by the foundation of the annuity payments from the CLATs were not direct or indirect uses of the foundation's assets for the benefit of disqualified persons since they were being used to satisfy the legal obligations of the Husband, Wife, or another disqualified person.

The IRS found that the agreement between the foundation and the hospital ran from the private foundation to the hospital foundation and did not personally obligate the Husband or Wife. Consequently, payment of this obligation did not constitute self-dealing. In addition, the obligation to fund specified payments to the hospital foundation for a term of years ran from the hospital to the trustees of the trust and did not personally obligate Husband or Wife. Consequently, this did not constitute self-dealing. A similar analysis was made with respect to the agreement with the museum. Since Husband and Wife were not personal obligors under the museum agreement, the payment by the foundation would not satisfy a legal obligation by the Husband or Wife. The same was true of any payment by the charitable lead annuity trust.

Letter Ruling 201323007 (June 7, 2013). IRS finds no adverse gift or estate tax consequences with respect to charitable lead trust whose charitable beneficiary is a private foundation established by grantor of the charitable lead trust.

Taxpayer created a charitable lead annuity trust (CLAT) of which taxpayer's son was the sole trustee. The beneficiary of the annuity interest was a private foundation established by taxpayer and taxpayer's spouse. The foundation directors were the taxpayer, spouse, son one and son two.

The Board of Directors amended the by-laws of the foundation to provide that during any time when the foundation was the beneficiary of a charitable lead trust, a charitable remainder trust, or other similar trusts and the charitable trust was established by a director, officer or substantial contributor to the foundation, the director, officer or substantial contributor establishing the charitable trust would be prohibited from acting on or involvement in matters concerning the receipt, investment, grant or distribution of any or other decisions involving funds received by the foundation from such charitable trust. In addition, any funds received from a charitable trust would be segregated into a separate dedicated account and separately accounted for on the books and records of the foundation in a manner that clearly allowed the tracing of the funds into and out of such separate account.

The IRS first found that the funding of the CLAT will be a completed gift for federal gift tax purposes. This was because the taxpayer had not retained a power over the property transferred to the trust and had not retained any interest, reversion, or right to alter, amend or revoke the trust. The trust instrument specifically provided that the taxpayer could not serve as a trustee of the trust. In addition, although he was one of the directors of the foundation, he was not permitted to take any actions with respect to disbursements or grants of funds received from the CLAT.

The IRS also ruled that the taxpayer would be entitled to a gift tax charitable deduction for the fair market value of the annuity on the date of the gift. Finally, the IRS found that taxpayer had not retained any interest under either Section 2036 or Section 2038 which would cause the property in the CLAT to be included in taxpayer's estate at his death. At the end of the annuity term, the remaining trust property was to be distributed to an existing trust for the benefit of taxpayer's three sons. Taxpayer could not serve as trustee of the trust and could not participate in any action of the foundation concerning the annuity funds. Thus, taxpayer retained no interest or reversion in the trust and had no right to alter, amend or revoke the trust that would cause inclusion in taxpayer's estate at taxpayer's death.

H. A "publically traded security" means exactly that.

<u>Todd v. Commissioner</u>, 118 T.C. No. 19 (April 19, 2002). Stock transferred to private foundation was not qualified appreciated stock, and must be valued at its basis, not its fair market value.

John and Tate Todd formed the Todd Family Foundation, and subsequently transferred 6,350 shares of stock in Union Colony Bancorp to it. In filing their income tax return, the Todds claimed an income tax charitable deduction of $553,847, the fair market value of the stock. On the return, the Todds provided information concerning the gift, including their original cost ($33,338), the fair market value of shares ($553,847), and a statement of the method used for determining fair market value (sale). The Todds, however, did not complete the portion of the form that provides for appraiser certification. Nor did the Todds attach an appraisal summary.

On audit, the IRS disallowed the charitable deduction (except for $33,338 – the Todds' basis). The IRS asserted that the shares were not qualified appreciated stock and, therefore, the gift to the private foundation must be valued at its basis. Alternatively, the IRS argued that the Todds failed to comply with the substantiation requirements for claiming charitable contributions for gifts of appreciated property that exceed $5,000 in value and are not publicly traded stocks. The Tax Court agreed with both positions taken by the IRS.

Under Section 170, stock transferred to a private foundation must fall within the definition of qualified appreciated stock in order for the donor to claim a charitable income tax deduction for the fair market value of the stock. The court determined that market quotations with respect to the stock were not readily available on an established securities market. On the date of the transfer, Bancorp was not listed on any stock exchanges, nor were shares regularly traded in any over-the-counter market for which published quotations were available.

The court rejected the Todds' claim that the market quotation requirement was met because Bancorp shares were occasionally traded through a placement agency. Although the placement agent provided a suggested share price based on the net asset value, shares were not necessarily then available for sale. Further, the placement agent charged 25 cents for each share placed, and acted as a placement agent as an accommodation to the bank. Therefore, the suggested share price by the placement agent was not a reliable proxy for a market valuation. Based on this conclusion, the court held that that there were no readily available market quotations and the shares were not qualified appreciated stock. The court further held that the transfers were subject to substantiation requirements, which the Todds had not met.

I. A vow of poverty does not prevent the IRS from asserting estate tax.

Technical Advice Memorandum 200437032 (September 10, 2004). Residuary bequest to member of religious order who has taken a vow of poverty does not qualify for the estate tax charitable deduction.

A decedent left the residue of his estate to his sister. Prior to the death of the decedent, the sister had joined a religious order and taken a vow of poverty. The sister's religious order was the designated taker in default. The sister, who also acted as executor of the decedent's estate, transferred the assets of the estate to the order more than nine months after the decedent's death. The issue in this technical advice memorandum was whether the gift could qualify for the estate tax charitable deduction.

The IRS first addressed the issue of whether the gift to an individual, which the individual is required to transfer to a religious order pursuant to a vow of poverty at the time of the decedent's death, would qualify for the estate tax charitable deduction under Section 2055. The IRS found that the property did not pass from the decedent to the religious order pursuant to the terms of the testamentary instrument. Rather, the property passed to the religious order from the individual subject to the vow of poverty, pursuant to a contractual arrangement between the individual and the order. The IRS cited Revenue Ruling 68-459, 1968-2 C.B. 411, and Revenue Ruling 55-759, 1955-2 C.B. 607 for this construction. A similar result was reached in Estate of Callaghan v. Commissioner, 33 T.C. 870 (1960). Because the bequest did not pass directly to the order, it would not qualify for the estate tax charitable deduction.

The next issue was whether the sister's vow of poverty constituted a qualified disclaimer meeting the requirements of Section 2518(a). If it did qualify as a disclaimer, the sister would be treated as predeceasing the decedent and the disclaimed interest would pass to the order pursuant to the residuary clause of the decedent's will.

The IRS found that a vow of poverty entered into by the sister was not a qualified disclaimer under Section 2518. It did not satisfy the state law requirements for a valid disclaimer, such as being filed with the appropriate probate court. The vow did not have the effect of treating the sister as predeceasing the decedent for inheritance purposes.

In addition, the IRS concluded that the transfer of the assets to the order did not meet the requirements of Section 2518(c)(3), which treats certain written transfers of property as disclaimers. The IRS stated that Section 2518(c)(3) will apply only if a state law disclaimer was not available at the time of the transfer. It stated that the provision could not be viewed as a catch-all provision to save defective or disqualified disclaimers. Here, the IRS focused on the failure of the sister to make a disclaimer within the nine month period after the decedent's death. In addition, the IRS rejected the estate's argument that the sister's vow of poverty resulted in the termination of the sister's interest in the bequest.

This ruling points out the importance of following the requirements for a valid disclaimer under Section 2518. One of the most important of those requirements is that the

disclaimer be made within nine months of the date of the decedent's death in order for it to be valid. The failure to obtain the estate tax charitable deduction in this situation could have been avoided if the sister had made a qualified disclaimer within nine months of her brother's death.

J. Conservation easement should be conservative in nature.

<u>Whitehouse Hotel Ltd. Partnership v. Commissioner</u>, 755 F.3d. 236 (5th Cir. 2014). Court of Appeals affirms Tax Court's ruling disallowing a significant portion of a tax deduction for historic conservation easement but permits the use of the good faith exception to prevent imposition of a 40% gross overstatement penalty.

Whitehouse was formed in 1995 to purchase the Maison Blanche building in New Orleans and then renovate and reopen it as a Ritz-Carlton hotel and condominium complex with retail space. On December 29, 1997, Whitehouse conveyed a conservation easement to the Preservation Alliance of New Orleans. The easement involved maintaining the appearance of the ornate terra cotta façade of the building. On its 1997 tax return, Whitehouse claimed a $7.445 million income tax charitable deduction for the easement.

In 2003, the IRS allowed a charitable income tax deduction of only $1.15 million for the easement and assessed a gross valuation penalty of 40% of the underpayment of tax. Whitehouse challenged the valuation of the easement and the gross valuation penalty in the Tax Court in 2008. The government's appraiser and the Whitehouse's appraiser did not agree on what property was to be valued. Whitehouse's appraiser included an adjacent building because it was to be brought under common ownership the day after the creation of the easement. The appraisers disagreed over the highest and best use of the Maison Blanche building. Whitehouse's appraiser used three methods, the replacement cost, income, and comparable sales methods, to determine a $10 million value of the easement. The government's appraiser used only the comparable sales method and concluded that Maison Blanche was worth $10.3 million pre- and post-easement and that the easement had no value. The Tax Court in 2008 determined that the easement had a value of $1.792 million and imposed a 40% payment for gross undervaluation.

Whitehouse appealed the 2008 Tax Court decision to the Fifth Circuit. The Fifth Circuit in 2010 remanded to the Tax Court and requested that the Tax Court reconsider all valuation methods, that it determine the parcel's highest and best use for purposes of the valuation, and that it consider the effect of the easement on the adjacent building, even if the easement itself did not specifically burden that building under Louisiana law. It also directed the Tax Court to determine whether the highest and best use would be as the luxury hotel actually being built or instead as a non-luxury hotel. The Tax Court in 2012 found that, on the date of the imposition of the easement, the proper valuation was not of the development of the luxury hotel but of a shell building suitable for conversion to a hotel. It determined that the value of the easement was $1.857 million. This resulted, once again, in the application of the gross undervaluation penalty.

The Court of Appeals affirmed the Tax Court's second decision. However, it vacated the enforcement of the gross undervaluation penalty. It found that obtaining a qualified appraisal, analyzing that appraisal, commissioning another appraisal, and submitting a professionally prepared tax return is sufficient to show a good faith investigation as required by law. It noted that it was skeptical of the Tax Court's conclusion that following the advice of accountants and tax professionals, as had been the situation here, was insufficient to meet the requirements of the good faith defense, especially in regard to a complex task that involved many uncertainties.

Scheidelman v. Commissioner, T.C. Memo 2013-18. Tax Court finds that charitable façade easement has no value.

This case returned to the Tax Court on remand from the United States Court of Appeals for the Second Circuit, Scheidelman v. Commissioner, 682 F.3d. 189, in which the Second Circuit determined that the appraisal relied upon on the homeowner's 2004 tax return was a qualified appraisal for purposes of obtaining the income tax charitable deduction and, consequently, the income tax charitable deduction could not be denied for lack of a qualified appraisal. In this case, the Tax Court examined the value of façade easement to determine the amount of the income tax charitable deduction.

Scheidelman purchased property in the Fort Greene Historic District in Brooklyn, New York for $255,000 in 1997. In 2004, Scheidelman granted a façade conservation easement to the National Architectural Trust. An appraiser was hired to appraise the property and the value of the façade conservation easement. The appraiser determined that the market value of the property was $1,015,000 as of the appraisal date, using the three basic approaches to value (comparable sales, cost, and income). The appraisal noted that the façade easement value tended to be about 11 to 11.5 percent of the total value of the property for most attached row properties in New York City such as the subject property. It valued the façade conservation easement at $115,000, which reduced the value of the property to $900,000.

The Tax Court on remand rejected the reduction in value found in the appraisal. It focused on the manner in which the value was reached, the reliability of the methodology, and the persuasiveness of the appraisal as applied to the facts. The court noted that the appraiser based the discount not on comparables but on an analysis of the amount of the discount that the courts and the IRS had allowed in prior cases. The IRS produced valuation experts who concluded that the imposition of a façade conservation easement did not materially affect the value of properties such as the one under review. As a result, the court determined that the façade conservation easement had no value for purposes of the income tax charitable deduction.

<u>Graev v. Commissioner</u>, 140 T.C. No. 17 (June 24, 2013). Taxpayers are not entitled to income tax charitable deductions for gifts of cash and conservation easement because the receiving organization promised to refund the cash and remove the easement if the deductions were disallowed.

Graev purchased a New York City property that was listed on the National Register of Historic Places in 1999 for $4.3 million. Graev became interested in placing a charitable easement on the property because a neighbor across the street had contributed a façade easement to the National Architectural Trust (NAT). The neighbor had received a side letter from NAT that promised a return of the contribution if the charitable income tax deduction was disallowed. NAT entered into the same sort of transaction with Graev. He provided a façade conservation easement application to NAT on September 20, 2004, and he also made a cash contribution to NAT. On September 24, 2004, NAT sent the side letter to Graev indicating that if the IRS disallowed the income tax charitable deductions in their entirety, it would refund the cash contribution and work to remove the façade conservation easement from the property title.

In October 2004, the appraisal firm appraised the property at $9 million and concluded that the easement would reduce its value by 11 percent or $990,000. In addition to the contribution of the façade easement, Graev made $99,000 in cash contributions to NAT. The IRS challenged the income tax charitable deduction because it was made subject to subsequent events and thus conditional. The IRS said that conditional gifts do not qualify for the income tax charitable deduction. The IRS's denial related both to the $544,449 income tax charitable deduction claimed on the Graevs' 2004 joint return and the carryover charitable income tax contribution deduction of $445,551 made on their 2005 joint return.

The court concluded that there was a substantial possibility that the IRS would challenge the Graevs' income tax charitable deduction because of the reimbursement provision. It also rejected the Graevs' argument that neither state nor federal law would prevent enforcement of the side letter. Even apart from the legal enforceability of the side letter, it reflected what NAT was likely to do in the event of disallowance by the IRS. Consequently, since the charitable gift was conditional, it did not meet the requirements of Section 170 for an income tax charitable deduction.

<u>Gorra v. Commissioner</u>, T.C. Memo 2013-254. Value of façade easement greatly reduced and taxpayers were responsible for gross valuation misstatement penalties regarding the income tax charitable deduction.

In 2006, Husband and Wife gave a conservation easement on their townhouse on East 91st Street in New York to the Trust for Architectural Easements which was then known as the National Architectural Trust. In addition, Husband and Wife donated $45,000 in cash to the Trust for Architectural Easements. Husband and Wife had the property appraised. Although the house had been listed for sale immediately prior to the donation of conservation easement at $5,295,000, the appraiser used a market value of $5,500,000 in determining the value of the easement. The appraisal stated that on the basis of the data

and analysis presented, the value of the historic preservation easement was equal to 11% of the property's market value or $605,000.

The IRS denied the income tax charitable deductions which were partially taken on each of their 2006 and 2007 income tax returns.

The court found that the easement had a conservation purpose, that it could not be extinguished by mutual agreement, and that it was contributed exclusively for conservation purposes. Both Husband and Wife and the IRS submitted reports regarding the value of the easements. The IRS and Husband and Wife agreed that the value of the townhouse before the placement of the conservation easement was $5,200,000. The IRS believed that the value after the conservation easement was $5,300,000 that the easement had not influence on the fair market value. Husband and Wife's expert believed that the value was $4,735,000 after the easement resulting in an easement value of $465,000.

The court found first that the IRS was wrong in its assertion that the easement had no value. It noted that the easement was more restrictive than local law. But it also noted that the Husband and Wife failed to meet their burden of proof that the value of the easement was $465,000. The court, in reviewing the appraisals, determined that the value of the easement was $104,000.

The court also imposed the 40 percent penalty for gross valuation misstatement. It noted that the reasonable cause exception does not apply when a gross valuation misstatement applies to charitable donations.

IV. Estate Inclusion

A. If property can be excluded from estate tax, it is wise to let the client know.

Kinney v. Shinhalser, 663 So. 2d 643 (Fla. App. 5th Dist. 1995), review denied, 671 So. 2d 788 (1996). Child of decedent could not pursue malpractice action against attorney who drafted will to give surviving spouse a general power of appointment over residuary trust, but could pursue action against attorney and accountant who represented estate and failed to advise spouse about using disclaimer to make use of unified credit.

This case provides an interesting illustration of when a practitioner may have duties to the intended beneficiary of a client. Mr. Kinney's Will provided that the entire residue of the estate be left in trust for Mrs. Kinney. Mrs. Kinney was entitled to the entire net income of the trust. The Kinney's son, as trustee, had discretion to distribute trust principal to his mother. The trust gave Mrs. Kinney a testamentary general power of appointment. The entire trust was included in Mrs. Kinney's estate at her death, due to her general power of appointment. The Kinney's son sued the lawyer who drafted the Will alleging that he failed to provide for use of the unified credit in Mr. Kinney's estate. He also sued the lawyer and accountant who handled the administration of Mr. Kinney's estate, alleging that they failed to advise Mrs. Kinney and the son that Mrs. Kinney could disclaim the

power of appointment and that the executor could then make a partial QTIP election over the trust in order to utilize the unified credit.

The court granted summary judgment to the drafting attorney because there was no evidence that Mr. Kinney had intended that his Will be drafted to minimize estate taxes at the second death. Absent such evidence, the court concluded, the Kinney's son had no grounds to claim that the attorney breached a duty to the son.

The court found, however, that the son was a known, intended beneficiary in connection with administration of the estate. Therefore, he did have standing to sue the professionals hired by the executor for their failure to advise the spouse and executor about steps that could be taken to minimize future estate taxes.

B. Don't be creative with the ascertainable standard.

Letter Ruling 9030032 (April 27, 1990). A surviving spouse who, without the consent of an adverse party, can distribute principal of a credit shelter trust to herself for "support and comfort in the manner in which she is accustomed" possesses a general power of appointment over the credit shelter trust that will cause the trust property to be included in her estate.

This ruling illustrates the danger of not using one of the examples of an ascertainable distribution standard provided in the Treasury Regulations when a trust beneficiary is acting as trustee. The will being reviewed in this ruling created a nonmarital trust at the death of the testator equal to the maximum amount that can be sheltered by the unified credit. The surviving spouse and one of the children were named as co-trustees. If the child failed to act as a trustee, the other three children were named as successor co-trustees, with a specific order of succession. All the children were adults.

The Service first states that "support and comfort in the manner in which she is accustomed" is not an ascertainable standard because "comfort" is not limited to the health, education, support or maintenance of the beneficiary. The ruling notes that slightly modified standards, such as "support in reasonable comfort" or "support in his accustomed manner of living" would be ascertainable.

Because the standard for distribution of principal in the credit shelter trust is not ascertainable, the spouse would be treated as possessing a general power of appointment over the trust, unless the power is exercisable only in conjunction with a person having a substantial interest in the trust that is adverse to the spouse's exercise of the power in favor of herself. In this case, the child acting as co-trustee is considered to have a substantial adverse interest because the children are beneficiaries of the credit shelter trust at the spouse's death. However, if all four children fail or cease to act as co-trustees, the spouse, as sole trustee, would have a general power of appointment.

In some states, "comfort" is interpreted to be limited to support and maintenance. However, the IRS is reluctant to accept state law interpretations of standards of distribution unless the interpretation is clearly established by statute or case law from the

state's highest court. It would be far easier in this situation to modify the standard to fall within the accepted parameters of an ascertainable standard.

Foresee v. United States, 76 F. Supp. 2d 1135 (D. Kansas 1999). Trustee's power to distribute principal of trust to himself for "happiness" was a taxable general power of appointment.

After Wife's death in 1989, property was held in a credit shelter trust for the benefit for her husband. Husband was entitled to all the income for life, as well as principal for happiness, health, support and maintenance. Husband was the trustee of this trust until his death in 1993. The issue was whether the standard for distribution was an ascertainable standard relating to the husband's health, education, support or maintenance or was a nonascertainable standard. Treasury Reg. § 20.2041-1(c)(2) states that the "happiness" of the holder is not an ascertainable standard. Husband's estate argued that under Kansas law, happiness was an ascertainable standard. The court disagreed with the estate's argument and found that happiness was not an ascertainable standard under Kansas law. Therefore, Husband had a general power of appointment over the trust. The amount of additional tax caused by inclusion of the trust in Husband's estate was approximately $170,000.

This case points up, once again, the desirability of using only those distribution standards cited in Treasury Reg. § 20.2041-1(c)(2) as ascertainable standards, if a beneficiary is going to act as trustee and the trust is not intended to be included in the beneficiary's estate (as is the case with a credit shelter trust).

C. A retained interest in property can be implied.

Estate of Schauerman v. Comm'r., T.C. Memo 1997-242, 73 T.C.M. (CCH) 2855 (1997). Partnership interests transferred by decedent are includible in her estate under Section 2036(a) because she retained the income from the interests.

In general, an individual can retain control over the activities of a limited partnership as general partner without having transferred limited partnership interests brought back into his or her estate under Section 2036 or 2038. The IRS has ruled privately on several occasions that the general partner's fiduciary obligations to limited partners prevent application of Sections 2036 and 2038. The ability to give away limited partnership interests but retain management and control over the partnership assets is one of the significant advantages of a limited partnership.

There are situations in which Section 2036(a) can apply to a limited partnership, however. In Schauerman, the court determined that limited partnership interests that the decedent had transferred to family members should be included in her estate because all the partnership income continued to be deposited in the decedent's bank account after the partnership was created. This ruling illustrates why the formalities of a partnership must be followed. If the partnership agreement provides that partnership distributions are to be made proportionately to the partners based on their percentage interests, then this must be

done. In this case, virtually all the assets used to fund the partnership came from the decedent, and the decedent in effect continued to treat them as her own.

The court noted that Section 2036(a) can apply where there is an implied understanding that the transferor will retain the benefits of property. The evidence that partnership distributions all were deposited into the decedent's bank account was sufficient for the court to find such an implied understanding.

D. Ignoring the rules to provide for a parent may be noble but is not good tax planning.

Estate of Abraham v. Commissioner, 408 F.3d 26 (1st Cir. 2005); cert. denied, Cawley v. Commissioner, 126 S.Ct. 2351 (June 5, 2006). Discounts for family limited partnerships disallowed because decedent had a Section 2036 interest.

The Supreme Court on June 5, 2006, denied certiorari in this case. As a result, discounts for family limited partnership interests in a decedent's estate were disallowed.

The First Circuit Court of Appeals upheld the decision of the Tax Court, T. C. Memo 2004-39, that Section 2036 applied to three family limited partnerships. Ida Abraham suffered from Alzheimer's disease and was placed under a guardianship. In 1995, a Massachusetts' probate court approved an estate plan for Ida under which three pieces of commercial real property were transferred to three separate limited partnerships in which Ida and her three children were the partners. Interests in the partnerships were transferred from the partnerships to the children during her life. Upon Ida's death in 1997, the estate claimed minority interest and lack of marketability discounts for her interests.

This is a case of bad facts making bad law. The Massachusetts probate court decree provided that the assets in the partnership would always be available for her. One daughter testified at trial:

> The partnerships assured that [Mrs. Abraham] would be constantly protected. She would never want for anything. There would always be money there. And if there wasn't money in her partnership fund, it come out of my partnership shares or my brother's, but that protection was there for her as a guarantee that she would live status quo.

The decree also provided that the limited guardian ad litem would be able to determine any shortfall generated from Ida's segregated property and how the shortfall could be made up from each of the separate limited partnerships

The IRS asserted that Ida retained the income from and the use and enjoyment of the property transferred to the three family limited partnerships and therefore Section 2036 applied. The court rejected the estate's first argument that the bona fide sale for full and adequate consideration exception applied since Ida, through her guardian, could divert all of the income in the family limited partnership for her needs. The court also rejected the estate's second argument that Ida did not retain the use and enjoyment of the transferred property. Instead, the facts showed just the opposite. Her ability to have the partnerships

make up any shortfall in income generated from her personal assets was a clear retention of the income from the property and the use and enjoyment of the property.

<u>Estate of Disbrow v. Commissioner</u>, T. C. Memo 2006-34. House contributed by decedent to general partnership established with children was included in gross estate under Section 2036(a)(1) because decedent continued to reside in it and failed to pay fair market rent.

After her husband's death, Lorraine Disbrow owned outright a home in New York. At the time of her husband's death, Lorraine was in failing health and her health continued to be poor until her death. She had kidney problems, peritonitis, fractured bones, had suffered multiple heart attacks, and was also feeble and mentally unstable.

Her attorney advised Lorraine that she could save taxes and costs by transferring her home to a general partnership. According to the attorney, Lorraine could then give all of her partnership interests to her family and continue to live in the residence as a tenant, but not have the house subject to federal estate tax. Lorraine and her children formed a general partnership agreement called Funny Hats. Lorraine received a 28% interest in the partnership. Each married child and his or her spouse received a 7.2% interest. The one single child received a 14% interest. None of the partners contributed any assets to the partnership upon its formation. Lorraine then transferred the residence to Funny Hats for no consideration. On the date of the transfer, the partners told Lorraine that she could continue to live in the home as long as she furnished the funds necessary to maintain it. Several months later, Lorraine gave her 28% interests in Funny Hats to her children and their spouses. This reduced Lorraine's interest to zero. The IRS, in auditing Lorraine's estate, included the property in her estate because it viewed the transaction as a sham. It believed that Section 2036 applied since Lorraine had retained the use of the house until death and had not paid adequate rent.

In analyzing whether Section 2036 applied, the court noted that although the partnership was created to establish and conduct the business of real estate ownership and management, the partnership conducted no business and was not operated with intent to make a profit. The sole assets of the partnership were the residence and a checking account, almost funded entirely by Lorraine. Lorraine had a boiler plate lease with the partnership for the use of the house. After giving her partnership interest in Funny Hats to the other partners, she wrote eight checks to the partnership, six of which were designated for rent. Lorraine paid most of the expenses connected with the residence. Lorraine also did not always pay the amount of rent stated in the lease agreement and was often late in her payments of the rent. Lorraine died in 2000 when the fair market value of the residence was $400,000. Ten months after her death, the partnership sold the residence to a son for $350,000. No attempt was made to obtain an outside bid for the residence or otherwise sell it on the open market.

This appears to be a classic case in which an individual retained the use and enjoyment of property that she had given away, resulting in inclusion in the decedent's estate under Section 2036(a)(1). This result could possibly have been avoided if Lorraine had been

treated the same way as an outside tenant would have been treated and paid fair market rent for the property.

V. Buy-Sell Agreements

A. An agreement without the characteristics of an arm's-length agreement will be a testamentary device.

Bommer Revocable Trust v. Comm'r., T.C. Memo. 1997-380, 74 T.C.M. (CCH) 346 (1997). Buy-sell agreement with price for stock determined by nonprofessional appraiser and with no price adjustment provision is a testamentary device.

Bommer Revocable Trust provides further insight into the requirements that must be satisfied in order for a price provision in a buy-sell agreement to be binding for estate tax purposes. The court in this case reinforced the decision in Estate of Lauder v. Comm'r., T.C. Memo 1992-736, by concluding that there is a strong presumption in favor of treating a buy- sell agreement among family members as a device for transferring stock for less than full and adequate consideration ("a testamentary device"). While both Bommer and Lauder involved buy-sell agreements not subject to Section 2703 of the Code, the decisions are very relevant. The common law test of whether an agreement constitutes a testamentary device still applies under Section 2703, and the factual analysis underlying the testamentary device question is the same.

The decedent in Bommer owned 86% of the outstanding stock in a family owned company, the CamVic Corporation. The remaining shares were held by the decedent's wife (1.9%), his son (8.9%), and his three grandchildren (1.3% each). In 1975, CamVic and its shareholders executed a buy-sell agreement that provided that if any shareholder wished to sell his or shares, the corporation would have the option within a stated time to purchase the shares for $11,333.30 per share, and that if it failed to exercise its option within the stated time, the other shareholders had the right to purchase the shares at the same price within a stated time. The agreement could be amended by the written consent of the holders of at least 75% of the issued and outstanding shares. The agreement did not provide for a periodic revaluation of CamVic's stock. The option price of the stock was calculated by the Bommer family's attorney/tax advisor, and was completed in one day and without benefit of a professional business valuation of CamVic or a professional appraisal of any of the properties owned by CamVic or its subsidiaries.

In 1981, CamVic and its shareholders entered into a revised version of the buy-sell agreement, making as its only significant modification a change from 75% to 87.5% in the percentage of stock ownership necessary to amend the agreement. As a result, under the revised agreement, the decedent could not unilaterally amend its terms, as he could under the original agreement. The revised agreement did not change the option price of the shares of CamVic, nor did it provide for a revaluation of the share price. The parties did not negotiate with respect to the option price before entering into the revised agreement. The revised agreement was dated the same date as the original agreement and signed by the parties as if they held the positions they held in 1975, rather than the ones they held in 1981.

After the decedent's death, the estate reported the stock at a value of $11,333.30 per share on the federal estate tax return. The IRS issued a deficiency notice reflecting its valuation of decedent's interest in CamVic at $75,278.22 per share. The court rejected the buy-sell price on several grounds, the most important of which was that it found that the buy-sell agreement was a testamentary device. The key factors in this determination were the fixed price for the shares which was not subject to revaluation; the lack of any bargaining over terms and price as there would be with unrelated parties; the fact that the option price was not the result of a professional appraisal; and the irregular manner in which the agreement was "revised". The court also noted that were shareholders are members of the same family and the agreement otherwise appears to be influenced by testamentary influences, the estate has the burden of demonstrating that the agreement establishes a fair price for the stock.

B. A depressing effect on value is not always good.

<u>Calloway v. Bank One, Texas</u>, No. 91-1761-P3(A) (November 30, 1993). Trustee liable for over $25 million for entering into a buy-sell agreement for the sale of closely-held stock.

In this Dallas County Probate Court decision, a bank was found liable to the trust beneficiaries for $25.8 million in actual and punitive damages, prejudgment interest, and attorney's fees for approving and entering into a buy-sell agreement on behalf of the trust. This case may cause corporate fiduciaries to hesitate when asked to enter into buy-sell or similar agreements on behalf of a trust for transfer tax purposes.

The settlor of the trust, William Wright, had transferred his majority stock interest in a closely held company to the trust. The stock constituted the sole asset of the trust. The bank, the settlor, and another stockholder in the company were named as trustees. The trustees subsequently executed a buy-sell agreement that contained various restrictions on the sale of the stock.

The guardian of the estate for William Wright sued the bank for breach of fiduciary duty. The guardian maintained that Wright, who suffered from Alzheimer's disease, was incompetent at the time the agreement was signed. The guardian contended that the buy-sell agreement was unfair to Wright, favored the minority shareholders (including the minority shareholder acting as co-trustee), and undermined the fair market value of his stock.

The bank was hit with a judgment for $5,247,964 in actual damages and prejudgment interest, $2,061,733 in attorney's fees, and $18,551,787 in punitive damages.

C. Don't ungrandfather a grandfathered agreement.

<u>Blount v. Commissioner</u>, 426 F.3d 1338 (11th Cir. 2005). Court finds that stock purchase agreement did not fix the value of stock for estate tax purposes.

George Blount and his brother-in-law each owned 50% of the outstanding shares of Blount Construction Company. In 1981, George, the brother-in-law, and Blount

Construction Company entered into a buy-sell agreement restricting the transfer of stock both during the shareholders' lifetimes and at death. Lifetime transfers required the consent of the other shareholders. At death, the shareholder's estate was required to sell and Blount Construction Company was required to buy the shareholder's shares at a price set in the agreement. The agreement could only be modified by the written consent of the parties to the agreement. Subsequently, George and the brother-in-law transferred shares to an ESOP established by Blount Construction Company. The brother-in-law then died and Blount Construction Company redeemed the brother-in-law's shares pursuant to the agreement. This left George and the ESOP as the only remaining shareholders, with George owning an 83% interest in Blount Construction Company.

In 1996, without obtaining the consent of the ESOP, George and Blount Construction Company, which George controlled, modified the agreement. They changed the price and the terms under which Blount Construction Company would redeem George's share on George's death. They left unchanged the provision requiring the consent of the other shareholders for lifetime transfers. The modified price was substantially below the price that would have been payable pursuant to the then existing agreement and which was paid for the brother-in-law's shares. George died and Blount Construction Company redeemed his shares as set forth in the modified agreement. George's estate reported the value of the shares held at death as equal to the price set forth in the modified agreement. The Tax Court held that the modified agreement should be disregarded for purposes of determining the value of George's share for federal estate tax purposes because George had the unilateral ability to modify the agreement rendering the agreement nonbinding during George's lifetime.

The court focused on the fact that to qualify for the exception to the general rule, under Section 2703, the restrictive agreement must be binding during the life of the decedent. It noted that by the time the 1996 agreement was consummated, the only remaining parties were the construction company and Blount. Blount owned an 83% interest in Blount Construction Company, was the only individual shareholder of Blount Construction Company, and was the President of the company. The estate argued that ESOP's approval was required for changes. However, the court noted that ESOP was not a party to the buy-sell agreement and thus that its consent was not necessary to modify the agreement. As a result, Blount essentially had the unilateral ability to modify the agreement during his life and he did so during his life and the value of the shares in George's estate had to be determined using a fair market valuation as required by Section 2703.

VI. Valuation.

A. Courts do not always find experts to be expert.

<u>Estate of Noble v. Commissioner,</u> T.C. Memo. 2005-2 (January 6, 2005). Court rejects all analysis of experts and relies on price of post-death sale of shares to determine federal estate tax value.

Helen Noble died on September 2, 1996 owing 116 shares of Glenwood Bank. The share represented an 11.6% interest. The remaining shares all were owned by a bank holding company, Glenwood Bancorporation.

The estate had reported the shares on the estate tax return at a value of $903,988. In October, 1997, the estate sold the shares to the holding company for $1.1 million. Not surprisingly, the IRS asserted that the $1.1 million value applied for estate tax purposes.

The court heard significant expert testimony, including from Mercer Capital on behalf of the estate. The court concluded that the expert's testimony was not the most probative evidence of value. It concluded that the sale approximately one year after death was the most relevant evidence. It cited several cases for the proposition that "actual sales made in reasonable amounts at arm's length, in the normal course of business, within a reasonable time before or after the basic date, are the best criterion of market value." Estate of Fitts v. Commissioner, 237 F.2d 729, 731 (8th Cir. 1956).

The taxpayer argued that the sale was not at arm's length and that it failed under the willing buyer-willing seller test because the holding company was a "strategic buyer" seeking to own 100% of the stock. As to the first point, the court noted that the estate had turned down an earlier, lower offer from the holding company. It concluded there was ample evidence of an arm's length transaction between unrelated parties. As to the second point, the court said it might be relevant if trying to distinguish the price in a purchase of similar shares. But, when the purchase in question is the purchase of the actual shares owned by the estate, it becomes the most relevant transaction and the questioning of distinguishing it from another sale becomes irrelevant.

The court did discount the value of the shares slightly, to reflect inflation during the time period between date of death and sale, and valued the shares at $1,067,000.

There were two other noteworthy facts in the case. First, the IRS expert had applied to 40.5% combined marketability and minority interest discount in his analysis. Second, the estate went to trial on this dispute, with high priced appraisers, when the difference in value between its reported estate tax value and the IRS value was only about $200,000. Something else, not explained in the opinion, was at work here, because that valuation difference does not justify the cost of a trial.

Koons v. Commissioner, Unpublished Opinion (11th Cir. 2017). Eleventh Circuit upholds decision of Tax Court denying deduction for non arm's length Graegin loan and accepts discount proposed by IRS for LLC interests in estate.

In this case, the Court of Appeals affirmed a decision of the Tax Court (T.C. Memo 2013-94) that denied a deduction for interest on a Graegin loan to the estate and accepted the valuation discount proposed by the IRS for LLC interests in the estate.

At John Koons' death in 2005, his revocable trust had a 46.94% voting interest and a 51.59% non-voting interest in CI LLC. CI LLC held the proceeds from the sale of the Pepsi distributorship business own by Koons and his family. The trust's LLC interests

represented 50.5% of CI LLC. The net asset value of CI LLC on the date of Koons' death was $317,909,786. The other owners of CI LLC on the date of Koons' death were family members or trusts for their benefit.

In February, 2006, CI LLC loaned the revocable trust $10.75 million in exchange for a promissory note to assist in the payment of the federal and state estate taxes. The promissory note for the loan bore interest at 9.5% rate, with repayment deferred for eighteen years and then payment in 14 semi-annual installments of $5.9 million between August 31, 2024, and February 28, 2031. The terms prohibited pre-payment. As a result of these terms, the total interest on the loan for its term would be $71,419,497. The estate claimed this amount as a Section 2053 administration expense deduction on the federal estate tax return.

The Tax Court had determined that the revocable trust did not need to borrow the $10.75 million from CI LLC in order to pay the federal tax liability. It found that there were significant liquid assets in the trust, more than $19 million worth. When the trust borrowed the money in February, 2006, its voting interest had increased to 70.42% because of redemptions of some of the other members' interests, and the LLC had over $200 million dollars in highly liquid assets. The revocable trust had the power to force CI LLC to make a pro rata distribution to its members that it then could have used to pay the taxes. The court based its decision on the fact that the trust had other ways to access funds to pay the estate tax, making the loan unnecessary.

Koons clearly stretched the limits of commercial acceptable loans with a high interest rate and significant deferral of payment. This almost certainly caused the IRS to closely scrutinize the estate tax return. An executor or trustee should be prepared to justify the need for a loan in order to pay estate taxes, and its reasonableness.

In those cases where there are not alternative sources of funds, such as an LLC that could have made distributions in Koons, taxpayers generally have been successful in deducting Graegin loan interest. An example is Estate of Purdue v. Commissioner, T.C. Memo 2015-249. The decedent's estate structured a Graegin loan with a family LLC of which it was member. The LLC had significant liquid funds, but the LLC terms required the consent of all the members to a distribution of the magnitude required by the estate, and one member refused to consent. The court allowed the interest deduction for the loan.

On the federal and state estate tax returns, the estate reported the fair market value of its interest in CI LLC at $117,197,443. This reported value was based on a report prepared by Mukesh Bajaj. This, in turn, was based on a marketability discount of 31.7%. At trial, the estate lowered the value of the revocable trust's interest in CI LLC to $109,651,854.

With respect to the amount of the marketability discount, the IRS used Francis X. Burns as its expert to counter the appraisal of Mukesh Bajaj. The court noted that Bajaj used a regression equation to determine the marketability discount while Burns did not. The court found that Bajaj's use of the regression equation to predict the marketability discount was flawed for four reasons. It noted that it was derived from

a data set of 88 companies that earned their profits mainly from active business operations while CI LLC had only 2 small operating businesses. Next, the regression equation explained only one- third of the discount in the ownership interests in the 88 companies from which the equation was derived. Third, Burns questioned the applicability of the regression equation to CI LLC since all 88 of the transactions used by Bajaj involved ownership interests of less than 50.5%. Fourth, Bajaj's regression equation overestimated the relationship between block size and the valuation discount. The court accepted Burns' valuation of the 50.5% interest in CI LLC as being $148,503,609, using a 7.5% discount.

Estate of Tanenblatt, T.C. Memo 2013-263. Appraisal excluded from evidence because taxpayer failed to comply with expert witness rules.

Upon her death, Diane Tanenblatt owned a 16.67 percent membership interest in a New York limited liability company which in turn owned a commercial building on East 18th Street in New York City. In determining the value of the membership interest, the building was first appraised by Jacques O. Tuchler using a sales comparison approach and an income capitalization approach. The value determined under the sales comparison approach was $22,800,000. The value determined under the income capitalization approach was $19,960,000. Tuchler assigned no weight to the sales comparison approach and concluded that the value of the building on the date of Tanenblatt's death was $19,960,000. MPI was then engaged by the estate to value the 16.67 percent membership interest. After adding the cash and other current assets of the limited liability company and subtracting the liabilities, MPI concluded that the net asset value of the LLC on an undiscounted basis was $20,628,221. MPI then applied a 20 percent discount for lack of control and a 35 percent discount for lack of marketability to reach a value of $1,788,000 for the 16.67 percent interest.

The IRS accepted MPI's calculation of the undiscounted net asset value of the LLC, but allowed discounts of only 10 percent for lack of control and 20 percent for lack of marketability. This resulted in a value of $2,475,882 for the 16.67 percent interest and caused an estate tax deficiency of $309,547.

The estate petitioned for a redetermination of the deficiency. In doing so, the estate attached a copy of a new appraisal by Laura J. Tindall which showed the value of the 16.67 percent interest as $1,037,796.

At trial, the IRS offered John A. Thomson as an expert. Thomson accepted the net asset value as being $20,628,221. He applied discounts of 10 percent for lack of control and 26 percent for lack of marketability. As a result, the rounded fair market value was $2,303,000 for the 16.67 percent interest.

The court did not allow the Tindall appraisal into evidence. The estate had attached the Tindall appraisal to its petition for redetermination. The court noted that Rule 143(g)(1) of the Tax Court Rules of Procedure requires that a party serve a copy of the report on the other parties. This was not done. In addition, the estate was unable to produce Tindall to testify because of a fee dispute between Tindall and the estate. The estate also failed to

qualify Tindall as an expert as required pursuant to Rule 702 of the Federal Rules of Evidence.

The estate called no witness to testify as to the value of the 16.7 percent interest. Instead the estate found fault with both the MPI appraisal (which was used to value the interest on the estate tax return) and with the IRS's expert. Judge Halpern, in an extensive analysis, accepted the IRS's appraisal with a 10 percent discount for lack of control and a 26 percent discount for lack of marketability. This caused the value of the 16.67 percent interest to be $2,303,000 for estate tax purposes.

Estate of Richmond v. Commissioner, T.C. Memo 2014-26. Tax Court determines value of decedent's interest in a family-owned personal holding company using a net asset value method and imposes a 20 percent accuracy-related penalty for substantial undervaluation on estate tax return.

Helen Richmond died on December 10, 2005. At the time of her death, she owned a 23.44% interest (consisting of 548 shares) in the Pearson Holding Company. Pearson Holding Company was a family owned investment company incorporated in 1928 as a subchapter C corporation. On the date of Helen Richmond's death, the shares were held by 25 family members whose interests ranged from 0.17% to 23.61%. The three largest shareholders (which included Helen Richmond) owned 59.20% of the shares.

Pearson Holding Company had a portfolio of marketable securities with a total value of $52.1 million and a stated investment philosophy of maximizing dividend income. Because of a slow turnover in securities that it held, Pearson Holding Company had a built-in capital gain tax liability of 87.5% of the value of its portfolio.

As the owner of less than a majority of Pearson Holding Company's stock, Helen Richmond could not unilaterally change the management or investment philosophy of the company, could not unilaterally gain access to corporate books, could not increase distributions from the company, and could not cause the company to redeem her stock. She had no rights to force the company to buy her shares and the company could not demand to buy her shares.

The two executors hired an accounting firm to prepare the federal estate tax return and to value the Pearson Holding Company stock. The accountant who prepared the valuation was a CPA and certified financial planner, but did not have any appraiser certifications. The accountant used a capitalization of dividends method that valued Helen Richmond's interest in Pearson Holding Company at $3.1 million. The accountant provided an unsigned draft of the valuation report to the executors and the return preparer, but was never asked to finalize the report. The estate, without any additional consultation with the accountant, reported the value of Helen Richmond's interest in Pearson Holding Company at $3.1 million on the federal estate tax return.

The Internal Revenue Service (IRS) on audit increased decedent's interest in Pearson Holding Company to $9.2 million and imposed a 40% gross valuation estate penalty of $1.1 million. At trial, the IRS's expert, John A. Thomson, using the stipulated net asset

value of $52.1 million, calculated Helen Richmond's interest to be worth $7.3 million, after applying a 6% minority interest discount and a 36% discount to account for the lack of marketability and for the built-in capital gain tax. The estate offered Robert Schweihs as its expert. He determined that the estate's interest was worth $5.0 million, using a capitalization of dividends method. Schweihs also valued the decedent's interest in Pearson Holding Company using the net asset value method and determined a value of $4.7 million. Schweihs applied an 8% discount for lack of control, as compared to Thomson's 6% discount and a 35.6% discount for lack of marketability (as compared to Thomson's 21%). Schweihs also used a dollar for dollar reduction to adjust for the built-in capital gains tax.

After hearing the expert testimony from both parties, the Tax Court determined that the fair market value of Helen Richmond's interest was $6.5 million. The court determined that the net asset value method should be used.

The court also imposed a 20% accuracy related penalty under Section 6662(a). This was because the amount reported on the estate tax return was less than 65% of the proper value. It also determined that the estate had lacked reasonable cause for its valuation and that the estate had not acted in good faith with respect to its valuation. Instead it noted that one of the co-executors was a CPA and the other co-executor had attended business school and had modest experience in financial matters. They had hired a CPA who, while having some appraisal experience, did not have any appraisal certifications. Moreover, the estate did not act with reasonable cause and in good faith because it used an unsigned draft report prepared by its accountant as the basis for reporting the value of the interest in the company.

B. Do it yourself valuation do not always work.

Estate of Giovacchini, T.C. Memo 2013-27. Valuation without professional appraisal support will not overcome price in subsequent sale.

Shirley C. Giovacchini died on October 8, 2001, after having been diagnosed with multiple myeloma in 1999. Shirley had owned a unique piece of real estate near Lake Tahoe, California called High Meadows. High Meadows covered approximately 2,350 to 2,500 acres and parts of it were quite mountainous and difficult to accurately survey or measure.

In 1999, Shirley transferred ownership of High Meadows to herself and her daughter, Lisa Lekumberry, as trustees of the Giovacchini Family 1989 trust. On June 27, 2000, the trust sold a 50 percent interest in High Meadows to High Meadows Six LLC, which was an entity controlled by Shirley's three daughters and their spouses. High Meadows Six LLC paid $2.5 million for its 50 percent interest. No appraisal was done with respect to the sale of the 50 percent interest. The sale price was determined by the family and by the family's CPA using the value determined by the appraisal for the estate of Shirley's

husband, Roy Giovacchini, who died in 1997, plus an annual increase for inflation based upon the consumer price index.

The estate argued that the value of the entire High Meadows property was $7.4 million in 2000 and $8 million in 2001. This would make the value of the 50 percent interest sold to High Meadows Six LLC in 2001 less than one half of $7.4 million and the value of the 50 percent interest taxable in Shirley's estate less than one-half of $8 million. The IRS argued that the values were $25 million in 2000 and $36 million in 2001, respectively. These values were based upon a subsequent sale of a large part of the High Meadows property to the U.S. Forest Service through a sale facilitated by the American Land Conservancy that occurred in 2003. The $29,500,000 price paid for all of High Meadows was based upon a December 2002 appraisal.

The parties agreed that depending upon the value, the sale of a 50 percent interest to High Meadows Six LLC in 2000 was a part sale and part gift.

The court in in its review took into account the January 31, 2003 sale of High Meadows as evidence of the value of High Meadows for both estate and gift tax purposes. It noted that, although subsequent events are generally irrelevant and therefore inadmissible in determining the fair market value of property as of a relevant valuation date, that guideline is generally inapplicable when the subsequent event is a sale of the subject property itself within a reasonable time of the relevant valuation date. It did note that there is an exception where "material changes in circumstances occur between the valuation date and the date of sale." It noted that the sale of High Meadows two years and seven months after the date of the gift and about 16 months after the date of Shirley's death was reasonably close to both relevant valuation dates. As a result, it determined that the January 2003 sale of High Meadows at $29,500,000 was the best evidence of value.

The court then engaged in a long analysis and review of the different appraisals offered by the appraisers for both the estate and the IRS. It determined that the value of High Meadows for estate tax purposes was $21,300,000 as of October 8, 2001. It determined that the value of High Meadows for gift tax purposes was $18,500,000 as of the date of the gift in 2000.

C. If your family forms a partnership, it helps if the primary family member knows it.

Estate of Powell v. Commissioner, 148 T.C. No. 18 (May 18, 2017). Tax Court includes entire value of underlying assets of family limited partnership in estate of decedent.

Powell is one or more of the recent cases exploring the viability of claimed valuation discounts for interests held by the decedent in a family limited partnership or limited liability company. It is a decision of the full Tax Court, sitting en banc. That gives the decision more weight, which is somewhat unfortunate because this is an example of bad facts make unfavorable law. Procedurally, Judge Halpren's opinion was agreed to by

seven other tax court judges. Two Tax Court judges concurred in the result only. Judge Lauber wrote an opinion concurring in the result only in which he disagreed with the theory on which the underlying value of the assets in the partnership were included in the decedent's estate. Judge Lauber's concurring opinion was joined by five Tax Court judges.

The first part of the decision focused on the IRS' use of Section 2036 to assert that no valuation discounts are appropriate because the underlying assets transferred to the LP or LLC should be brought back into the estate. Section 2036 will apply if:

1. Decedent made an inter vivos transfer of property;
2. Decedent retained the income from or the use and enjoyment of the property until his or her death; and
3. The transfer of property was not a bona fide transfer for full and adequate consideration.

The most cited case for the Service's Section 2036 argument is Estate of Bongard v. Commissioner, 124 T.C. 95 (2005). The Bongard case explains that there can be an implied agreement to retain the income from the transferred assets where the transfer to the partnership arguably leaves the decedent without adequate separate funds to support their lifestyle. In addition, the transfer will not be considered to be bona fide and for full and adequate consideration if there are not a legitimate and significant nontax reasons for forming the partnership.

The executor in Powell stood little chance of establishing significant nontax reasons for the partnership because its formation was very much a last minute transaction and done on behalf of the primary contributing partner. Jeffrey Powell, the son of Nancy Powell, created NHP Enterprises LP as Nancy's agent under a power of attorney a mere week before Nancy Powell died. He transferred $10 million of Nancy's assets, to the partnership for a 99 percent limited partnership interest. Her two sons contributed property for the one percent general partnership interest. The partnership had all the earmarks of a deathbed planning device with no purpose other than to reduce taxes. The Tax Court agreed with the IRS that there was an implied agreement to retain control of the use and enjoyment of the property by others under Section 2036(a)(2) and no significant nontax purpose for creation of NHP Enterprises.

The family's argument in response was that there could not be a retained implied agreement because, on the same day as the funding of the partnership, Jeff, again acting as agent, transferred Nancy's 99% LP interest to a charitable lead annuity trust. Therefore, there was nothing for Nancy to retain under Section 2036. This argument failed for two reasons. First, the power of attorney under which Jeff operated did not authorize gifts greater than annual exclusion gifts to anyone other than Nancy's descendants. Therefore, the transfer to the CLAT was voidable. Second, even if the transfer was not voidable, the transfer to the CLAT constituted a transfer of a retained Section 2036 interest made within 3 years of death (in this case within a week of death). Section 2035(a)(2) brings such transfers back into the estate.

This court applied Section 2036(a)(2) to bring the assets of the partnership back into the estate (which argument the family did not contest). The majority opinion stated that 2036(a)(2) applied since Nancy, in conjunction with the other partners, could dissolve the partnership and Nancy, through Jeff as general partner and as her agent under the power of attorney could control the amount of distributions from the partnership and the timing of those distributions. Judge Lauber noted that Nancy Powell clearly made a transfer of 10 million in cash and securities and she clearly retained the proverbial "string" that pulled those assets back into her estate.

The court adopted the arguments advanced in Estate of Strangi v. Commissioner, T.C. Memo 2003-15, aff'd, 417 F.3d 468, to show why the fiduciary duty limitation of United States v. Byrum, 408 U.S. 125 (1972) did not apply. Byrum held that the retention of the right to vote the shares of stock in a closely held corporation transferred to an irrevocable trust by the majority shareholder was not a retained right under Section 2036(a)(2) since any decision would be constrained by fiduciary duties to other shareholders. Here, the Tax Court went to great lengths to distinguish this case from the fiduciary duties in Byrum. These differences included the following: (i) the inability of Jeff as general partner and the agent under the power of attorney to act in ways that prejudiced Nancy's interests; (ii) Jeff owed duties almost exclusively to Nancy since Nancy owned 99 percent of the interests in the partnership; and (iii) the partnership conducted no business activities. This differs from Byrum, which involved an operating entity.

Powell follows two other recent cases in which the IRS successfully applied Section 2036, Estate of Holliday v. Commissioner, T.C. Memo. 2016-51 and Estate of Beyer v. Commissioner, T.C. No. 2016-183. The case is a prime example of why deathbed attempts to use a limited partnership or LLC to obtain valuation discounts stand a strong chance of failing.

D. Partnerships continue to face IRS scrutiny.

Streightoff v. Commissioner, T.C. Memo 2018 – 178. Court accepts government's valuation of limited partnership interests in decedent's estate

Streightoff had many of the characteristics of Powell, but for unknown reasons, the IRS did not pursue the same Section 2036 theories. Decedent, Frank Streightoff, was a resident of Texas when he died in 2011. During decedent's lifetime, his daughter, Elizabeth Streightoff, held the decedent's power of attorney.

On October 1, 2008, decedent through Elizabeth Streightoff, formed Streightoff Investments LP as a Texas Limited Partnership. Streightoff Investments during decedent's life did not hold meetings or have votes.

The partnership agreement stated that the purpose of Streightoff Investments was to make a profit, increase wealth, and provide a means for decedent's family to manage and preserve family assets.

Decedent funded Streightoff Investments with marketable securities, municipal bonds, mutual fund investments, other investments, and cash. As of January 31, 2009, 61.6

percent of Streightoff Investments 'assets consisted of marketable securities, 23.6 percent consisted of fixed income investments in municipal bonds, and 13.3 percent was invested in mutual funds.

Streightoff Management LLC was the sole general partner of Streightoff Investments. Elizabeth Streightoff was the manager of Streightoff Management. The Streightoff Investments partnership agreement provided that the general partner was in charge of conducting the business of the partnership. Decedent, his daughters, his sons and his former daughter-in-law were the original limited partners under the partnership agreement. The limited partners other than decedent received their limited partnership interest as gifts. Upon formation, decedent and the other partners had the following interests:

Partner	Percentage	Type
Streightoff Investments	1.00%	General
Decedent	88.99%	Limited
Elizabeth Streightoff	1.54%	Limited
Ann Fennell Brace	1.54%	Limited
Camille Schuma	1.54%	Limited
Jennifer Ketchurn Hodges	1.54%	Limited
Hilary Dan Billingalea	1.54%	Limited
Charles Franklin Streightoff	1.54%	Limited
Frank Hatch Streightoff	1.54%	Limited
Priscilla Streightoff	1.54%	Limited

Section 7.2 of the partnership agreement provided that a limited partner could not sell or assign an interest in Streightoff Investments without obtaining the written approval of the general partner, which approval would not be unreasonably withheld. Any partner who assigned his or her interest remained liable to the partnership for promised contributions or excessive distributions unless and until the assignee was admitted as a substitute limited partner.

On October 1, 2008, the same day that the decedent formed Streightoff Investments, he established the Frank D. Streightoff Revocable Living Trust and transferred his 88.99 percent interest in Streightoff Investments to the Revocable Trust. Frank Streightoff was the sole beneficiary and Elizabeth Streightoff was the trustee of the revocable trust. On October 1, 2008, decedent, through Elizabeth Streightoff executed an assignment of interest which designated the decedent as assignor and the revocable trust as assignee of the limited partnerships interests. Elizabeth Streightoff signed the transfer agreement in her capacities as the holder of the decedent's power of attorney, trustee of the revocable trust, and managing member of Streightoff Management.

After decedent's death in 2011, on decedent's federal estate tax return, Elizabeth Streightoff, as executor, elected the alternate valuation date. The net asset value of the 88.99 percent assets in the partnership on the alternate valuation date was $7,307,951.

The estate used a combined 37.2 percent discount for lack of marketability, lack of control, and lack of liquidity, and reported the value of the limited partnerships interest as $4,588,000.

The court first had to determine whether the interest transferred to the revocable trust was a limited partnership interest or assignee interest. It noted that the federal tax effect of particular transactions is governed by the substance of the transaction rather than its form. The court concluded that the decedent transferred a limited partnership interest to the revocable trust and not an assignee interest. The economic realities underlying the decedent's interest also support the court's conclusion that the transferred interests should be treated as limited partnership interests for estate tax purposes. That was because, regardless of whether an assignee or limited partnership interest had been transferred, there would have been no substantial difference before or after the transfer of the limited partnership interests to the revocable trust. Also, even though an assignee could not vote, the partnership held no votes before decedent's death.

The IRS used Juliana Vicelya and the estate used Howard Frazier Barker Elliot (HFBE). The court first determined that there was no discount for lack of control since the interest transferred was an 88.99 percent limited partnership interest which could control the partnership. It noted that limited partners with a 75 percent interest could remove general partners and a general partner's removal terminated the partnership. This gave decedent's interest control over the partnerships.

HFBE valued the interest as an assignee interest and concluded that a 13.4 percent discount for lack of control should be applied. Since the court determined that a limited partnership interest and not an assignee interest was transferred, a discount for lack of control was not appropriate. The IRS's appraiser determined that an 18 percent discount for lack of marketability was appropriate. This was based on the highly liquid nature of the underlying assets of the partnership. In addition, the diversification of the underlying assets would make an interest in the partnership attractive to a hypothetical buyer, and the amount of control provided to an 88.99 percent limited partnership interest was a factor favoring a lower discount. Finally, the right of first refusal in the partnership agreement warranted a lower discount. HFBE concluded that a 27.5 percent discount for lack of a marketability was appropriate. However, one HFBE appraiser testified that his analysis of the lack of marketability discount would have included different considerations if the interest was a limited partnership interest with voting rights under the partnership agreement, as the court determined. Consequently, the court determined that the interest should be valued using an 18 percent discount rate for lack of marketability as the IRS' appraiser proposed.

E. Split dollar insurance may not be an asset discounting technique.

Cahill v. Commissioner, T.C. Memo 2018-84; settled, Joint Stipulation of Settled Issues, Tax Court Docket 10451-16 (August 16, 2018). Taxpayer's motion for summary judgment with respect to split-dollar arrangement is denied.

Richard F. Cahill died on December 12, 2011. His son, Patrick Cahill, was named as executor. This case involves three split-dollar agreements that were executed in 2010 when Richard was 90 years old and unable to manage his own affairs.

Richard was the settlor of a revocable trust called the Survivor Trust. Patrick was the trustee of the Survivor Trust and was also decedent's attorney-in-fact under a California Power of Attorney. Richard's involvement in the three split dollar life insurance arrangements was effected solely through the Survivor Trust and was directed by Patrick Cahill either as decedent's attorney in fact or as trustee of Survivor Trust. The parties agreed that everything in the Survivor Trust on decedent's date of death was included in the decedent's gross estate. Decedent was also settlor of the Morrison Brown ("MB") Trust which was created in September 2010 by Patrick Cahill as decedent's agent. William Cahill was trustee of the MB Trust and the primary beneficiaries of the MB Trust were Patrick and his issue. The MB Trust owned three whole life insurance policies. Two policies were on the life of Shannon Cahill, Patrick Cahill's wife, and one policy was on the life of Patrick Cahill. The policy premiums were paid in lump sums as shown in the chart below.

	Policy Premium	**Policy Amount**
New York Life on Patrick Cahill	$5,580,000	$40,000,000
SunLife on Shannon Cahill	$2,531,570	$25,000,000
New York Life on Shannon Cahill	$1,888,430	$14,800,000
TOTAL	**$10,000,000**	**$79,800,000**

To fund these policies, three separate split-dollar agreements were executed by Patrick Cahill, as the trustee of the Survivor Trust, and William Cahill as trustee of the MB Trust. The Survivor Trust paid the premiums using funds from a $10 million loan from Northern Trust. The obligors on the loan were the decedent personally and Patrick Cahill as trustee of the Survivor Trust. Each split dollar arrangement was designed to take advantage of the economic benefit regime and avoid the loan regime. Upon the death of the insured, the Survivor Trust was to receive a portion of the death benefit equal to the greatest of the remaining balance on the amount advanced, the total premiums paid with respect to the policy, or the cash surrender value. The MB Trust would retain any excess.

Each split-dollar agreement also provided that it could be terminated during the insured's life by written agreement between the trustees of the Survivor Trust and the MB Trust. As of the date of Richard's date in 2011, the aggregate cash surrender value of the policies was $9,611,624. The estate's tax return reported the total value of decedent's interest in the split-dollar agreements at $183,700. In the Notice of Deficiency, the IRS adjusted the total value of decedent's rights in the split-dollar arrangements from $183,700 to $9,611,624, the cash surrender value of the policies.

The estate moved for partial summary judgment. A court may grant summary judgment when there is no genuine dispute as to any material facts and a decision may be granted as a matter of law. The court first found that Section 2036 and Section 2038 would apply in this situation. The estate tried to argue that neither Section applied because the decedent retained no rights with respect to the amounts transferred to justify application

of those Sections. However, the court noted that the decedent retained the right to terminate and recover at least the cash surrender value held in conjunction with the MB Trust and that those constituted rights under Section 2036 and Section 2038. The court then noted that with respect to the requirements in Sections 2036 and 2038, questions remained as to whether decedent's transfer of $10 million was part of a bona fide sale. It also noted that the issue of whether the transfer was for full and adequate consideration was a question of fact. It stated that the bona fide sale for adequate and full consideration exception was not satisfied because the value of what the decedent received was not even close to the value of what decedent paid.

The court also reviewed the argument of the government that Section 2703 would apply to the MB Trust's ability to veto termination of split-dollar arrangements. It found that split dollar agreements, taken as a whole, clearly restricted decedent's right to terminate the agreements and withdraw his investment from those arrangements. The court stated that the requirements of Sections 2703 were met and therefore denied the motion for summary judgment with respect to this. The court also noted that the parties had not addressed the exception in Section 2703(d) which provides for comparison with the terms of any similar arrangements entered into by persons in arms' length transactions.

The court also rejected the estate's contention that any part of the difference between the $183,700 that decedent allegedly received in return and the $10 million decedent paid would be accounted for as gifts and that to count the difference as part of the estate under Sections 2036, 2038 and 2703 would be double counting.

The estate also sought summary judgment that pursuant to Treas. Reg. § 1.61-22, the economic benefit regime would apply to split dollar arrangements. The IRS countered that the regulation did not apply for estate tax purposes and stated that the economic benefit regime rules only are gift tax rules. The court noted that to the extent that the regulations eliminated the gift tax treatment and that those transfers are relevant to the estate tax issues it would look at the regulations in deciding the case. The estate also argued that the court should modify the approach required by Sections 2036, 2038 and 2703 to avoid inconsistency between the statutes and the regulations. The court disagreed. First, it found no inconsistency between the estate tax statutes and the income tax regulations. It also disagreed with the estate's argument, which was confusing to the court, that because Treas. Reg. § 1.61-22 did not deem the difference to be a gift, then the entire $10 million transferred must have been for full and adequate consideration. As a result, the estate's motion for partial summary judgment was denied. The government did not move for summary judgment on any of the issues discussed.

The government and the estate settled on August 16, 2018. The estate conceded that the value of the decedent's rights in the split dollar arrangements was $9,611,624, the cash surrender value of the policies, the amount asserted by the government. The estate was also liable for a Section 6662 20 percent accuracy related penalty.

VII. Asset Protection Planning

A. Your money may be overseas, but you're still here.

Federal Trade Commission v. Affordable Media, 179 F.3d 1228 (9th Cir. 1999). Promoters of scheme to telemarket fraudulent investments to consumers were held in civil contempt for failure to repatriate funds held in offshore asset protection trust.

Denyse and Michael Anderson created a telemarketing venture that offered investors the chance to participate in a venture that sold talking pet tags and water-filled barbells through late night television. Investors were promised a 50% return in 60 to 90 days. The venture turned out to be a "Ponzi" scheme in which investors suffered tremendous losses. The Andersons had transferred their assets to a Cook Islands trust. When the Federal Trade Commission sought to recover money from the Andersons, they claimed that they were unable to recover the money in the Cook Islands trust because they had no control over the money.

The Andersons set up the trust in the Cook Islands in 1995 naming themselves as co-trustees with AsiaCiti Trust. Under the terms of the trust, if an event of duress occurred, the Andersons were removed as co-trustees and AsiaCiti was prohibited from repatriating assets. In 1998, when the FTC obtained a preliminary injunction, the Andersons faxed a letter to AsiaCiti requested repatriation of the assets in Cook Islands. AsiaCiti, citing the duress clause, refused. In the contempt proceeding at the district court level, the Andersons argued that they could not comply with the court order to repatriate the assets because to do so was impossible. The district court was not impressed and held the Andersons in contempt. The Ninth Circuit upheld the contempt finding.

The Ninth Circuit found that the Andersons' inability to comply with the repatriation order was the intended result of their own conduct. The court cited several articles discussing offshore trusts that essentially said that the purpose was to avoid U.S. judgments. One article stated.

> "A well drafted trust would ... make it impossible for the client to repatriate assets held by the trust. Impossibility of performance is a complete defense to a civil contempt charge." Engel. Using Foreign Situs Trusts For Asset Protection Planning. 20 Est. Plan 212 (1993).

The court determined, based on review of the evidence and of the literature promoting offshore trusts, that the Andersons could retain control of the trust. This was buttressed by the Andersons being designated in the trust as trust protectors who, as the court noted, exercised considerable control over the trust. In fact, the Andersons only resigned as trust protectors after they sent the letter requesting repatriation of the assets and the FTC, upon AsiaCiti's denial of the repatriation request, informed the district court that the Andersons were the trust protectors. Consequently the Ninth Circuit believed that the Andersons retained sufficient power over the trust to repatriate the assets.

This case does not spell the end of offshore asset protection trusts or the domestic protection trusts currently available in Alaska, Delaware, Nevada, and Rhode Island. The facts were unique. The Andersons appear to have been involved in a fraudulent scheme. Transfers to asset protection trusts are not effective if they are in fraud of creditors. Moreover, the Andersons retained too much control, both as trustees and trust protectors. They failed to follow the general rule that the less the amount of control retained, the greater the protection afforded by an asset protection trust. Courts, such as the Ninth Circuit was in this case, will be hostile to these trusts. Here the Andersons, through acting as co-trustees and trust protectors, gave the court sufficient grounds to hold them in contempt for failing to repatriate the assets.

B. Asset protection planning may require the patience of a Saint.

In re Lawrence, 279 F.3d 1294 (11th Cir. 2002) (new court order, 2006). Debtor held in civil contempt released from federal detention.

In 1991, Stephan Jay Lawrence created an off-shore trust and funded it with approximately $7 million. Two months later, an arbitration judgment was issued against him in the amount of $20.4 million. Over time, several amendments were made to the trust. For example, in February 1991, a spendthrift provision was added. In January 1993, the trust was amended so that the settlor's powers could not be exercised under duress or coercion and Lawrence's life interest would terminate in the event of bankruptcy. In March 1995, an amendment declared Lawrence to be an "excluded person" under the trust, which would prevent him from ever being a beneficiary of the trust. In 1999, the trustees issued a declaration of intent stating that the excluded person status was irrevocable.

In June 1997, Lawrence had filed a voluntary petition for bankruptcy. As part of the bankruptcy proceedings, the bankruptcy trustee sought an order directing Lawrence to turn over the assets of the trust. The order was granted and a conference was held to determine if Lawrence had complied. Lawrence alleged that the terms of the offshore trust made it impossible for him to recover the assets held in the trust. The Bankruptcy Court found that Lawrence had control over the trust through his retained powers to remove and appoint the trustees and to add and exclude beneficiaries. The Bankruptcy Court rejected Lawrence's impossibility defense and held Lawrence in contempt for failing to turn over the trust assets. On September 8, 1999, the Bankruptcy Court issued a contempt order. Lawrence declined to comply and on October 5, 1999, the Bankruptcy Court ordered his incarceration pending compliance. On July 31, 2000, the District Court affirmed both the order to turn over assets and the contempt order.

Lawrence appealed to the Circuit Court. In affirming the orders of the Bankruptcy Court, the Circuit Court felt constrained to remind both the District and Bankruptcy Courts that civil contempt sanctions are intended to coerce compliance with a court order. If a civil contempt sanction lost its coercive effect, it would become punitive and violate the due process rights of the debtor. The Circuit Court held that the court must make an individual determination in each case whether there is a realistic possibility that the debtor will comply with the order. In addition, while incarceration for civil contempt

may continue indefinitely, it cannot last forever. If a judge determined that Lawrence had the ability to turn over the trust assets, but would steadily refuse to do so, the judge would be obligated to release Lawrence because the incarceration would no longer serve the purposes.

On December 12, 2006, the district court judge, who had affirmed the contempt order in 2000, entered an order releasing Lawrence from incarceration for civil contempt. Despite the opposition of the bankruptcy trustee, the judge ruled that the continued indefinite incarceration of Lawrence no longer served the civil purpose of coercion. The judge found that there was no realistic possibility that Lawrence would comply with the contempt order.

The judge did allow the bankruptcy trustee to file a request for additional protections to prevent Lawrence from having access to the assets in the trust. The district court left open the possibility of further contempt proceedings if Lawrence failed in the future to comply with any further order of the Bankruptcy Court.

C. Settlements do not always settle a matter.

In re Olson, ___ F. Supp. 3d ___ (C.D. Cal. 2018). U.S. District Court declines to approve settlement of bankruptcy trustee with respect to offshore trust.

In 2010, Jana W. Olson was sued in California Superior Court by Passport Management LLC. Within a month of the service of the lawsuit, Olson transferred her beneficial interest in a self-settled Cook Islands offshore asset protection trust from herself to her two minor children for no consideration. This transfer had the appearance of a fraudulent transfer. Subsequently, Olson filed a petition for bankruptcy. Passport Management LLC became the primary creditor of the bankruptcy estate.

At some point, Olson agreed to repatriate the money in the self-settled Cook Islands trust and a stipulated order was entered by the bankruptcy court directing Olson to do so. The bankruptcy court's order specifically required repatriation but did not decide if the money was the property of the bankruptcy estate.

Olson then, according to the district court, proceeded to disobey the bankruptcy court's order by sabotaging the repatriation effort with a letter designed to convince the Cook Islands trustee that her request to repatriate the money was made under duress. As a result, apparently, the Cook Islands trustee refused to repatriate the money. The bankruptcy court then jailed Olson for more than a year for civil contempt. Eventually, the bankruptcy trustee decided that jail was not going to convince Olson to repatriate the funds in the trust from the Cook Islands. The bankruptcy trustee then negotiated an agreement with Olson and Olson's father and Olson's brother, as trustee of a new California trust with the two minor children as beneficiaries, under which the money would be returned to California with approximately 80 percent going to the bankruptcy estate and 20 percent to the California trust.

After the repatriation of the funds to California, the bankruptcy trustee moved for approval of the compromise agreement before the bankruptcy court. Passport Management opposed the motion claiming that there was no authority to disburse property of the bankruptcy estate in contravention of the priority rules and that, in any event, there was no reason to allow Olson effectively to be rewarded for her contempt. Passport Management LLC also argued that other pressure could have been brought to bear before a compromise was struck that allowed Olson or her family to retain part of the funds.

The bankruptcy trustee argued that the agreement was the only way to get property back into the reach of the United States court and that 80 percent was better than getting nothing at all. The trustee also believed that the fraudulent transfer claim could have been easily won, but that subsequent collection would have been virtually impossible because of the difficulty of seeking collection in the Cook Islands. As a result, the bankruptcy court granted the motion to approve the compromise, but declined to determine whether the trust funds held in the Cook Islands were always the property of the bankruptcy estate.

The district court rejected the compromise. First, the court said that without a judgment avoiding the transfers, the Cook Islands funds were not a part of the bankruptcy estate at the time of the petition. The transfers would have to be formally avoided through a fraudulent transfer claim to make the funds part of the bankruptcy estate. In addition, the bankruptcy court had no equitable duty to approve the compromise after Olson and her family arranged for the repatriation money in reliance on the settlement. This effectively minimized the independent role of the bankruptcy court in the process. The court also agreed with Passport Management that a benefit to Olson's minor children was an indirect benefit to Olson herself as the money set aside in trust was money that Olson did not have to pay for her children's welfare. The court then rejected the argument of the bankruptcy trustee that the minor children might be individually liable for their mother's debt as beneficiaries of the trust. The court noted that the normal rule is that beneficiaries are not liable for the wrongful acts of the trust. As a result, the district court rejected the settlement agreement.

VIII. The Alternate Valuation Date. An alternate valuation date election must be made on time.

<u>Eddie v. Commissioner</u>, 115 T.C. No. 10 (August 16, 2000). Decedent's estate not permitted to make alternate valuation date election because federal estate tax return was filed late.

Generally, the value of assets in a decedent's gross estate is determined at the time of the decedent's death. However, under Section 2032, the alternate valuation date can be used if the appropriate election is made. The alternate valuation date is six months after the date of the decedent's death, unless the asset is distributed, sold, exchanged, or otherwise disposed of during that six month period. If it is, the alternate valuation date for that asset is the date of the distribution, sale, exchange or other distribution. The decedent's executor may elect to use the alternate valuation date only if the election will decrease

both the value of the decedent's gross estate and the amount of estate tax otherwise due. Once an election to use the alternate valuation date is made, all property in the estate must be valued using the applicable alternate valuation date.

Section 2032(d)(2) provides that the alternate valuation date election may not be made if the federal estate tax return is filed more than one year after the time prescribed by law (including extensions) for filing such returns. Here, the executor filed the federal estate tax return more than 18 months after the extended due date for filing the return. As a result, the IRS lacked any discretionary authority to permit the executor to make the election, and the property had to be valued as of the date of the decedent's death. The estate had wanted to claim the alternate valuation date, because it held a large amount of BFI stock. On the date of death, the stock was worth approximately $5,722,000. On the alternate valuation date, the stock was worth about $5,370,000. Thus, there could have been considerable tax savings if the alternate valuation date could have been elected.

IX. Too many clients may cost a lot of cash.

Baker Botts LLP v. Cailloux, 224 S.W.3d 723 (Tex. App. 4th Dist. 2007). $65.5 million jury verdict against Wells Fargo and Baker Botts LLP thrown out on appeal.

Baker Botts did estate planning for Mr. and Mrs. Cailloux in 1994 in which Wells Fargo was named as executors under mirror wills and as trustee under various trusts. A foundation was also established of which the children were officers, but friends of Mr. Cailloux were directors. In 1996, a new estate plan was implemented for Mr. Cailloux under which a trust was established for Mrs. Cailloux's benefit during her life, $10 million would pass to previously established trusts for the children, and the balance would pass to the foundation. Mrs. Cailloux was given a testamentary power of appointment to descendants and charities. A family limited partnership was also established. Mr. Cailloux passed away before the estate planning could be finished which would have involved the funding of grantor retained annuity trusts. If Mrs. Cailloux were to die, there would be a tax bill of $32 million.

In doing post-mortem planning, Baker Botts devised a plan under which Mrs. Cailloux disclaimed her right to the marital estate. As a result, $65.5 million passed to the foundation and other charities designated in Mr. Cailloux's will.

Baker Botts was representing three different parties. First, it represented Mrs. Cailloux in her estate planning. Second, it represented Wells Fargo in it capacity as executor of Mr. Cailloux's estate and trustee of the various trusts Mr. Cailloux had created. Third, it represented the foundation. Baker Botts sent engagement letters to all three parties informing them of the possible conflict in the joint representation. However, the engagement letter for Mrs. Cailloux was sent through Wells Fargo and was never discussed with Mrs. Cailloux.

Signs of trouble arose immediately. The children had expected to become directors of the foundation, but the current directors did not permit that. Baker Botts expressed some

concern that conflicts might be arising, but continued to represent the three parties and do the estate planning which resulted in $65.5 million passing immediately to the charities.

Baker Botts had several brief meetings with Mrs. Cailloux and one son about the different options. Mrs. Cailloux decided not to exercise the limited power of appointment because of her respect for Mr. Cailloux. Instead she withdrew from the family limited partnership, and created a new foundation in which her children would be involved. This was executed in a meeting that lasted 45 minutes. Baker Botts at this point withdrew from the representation of the old foundation because the implementation of the new plan would involve court proceedings.

A month later, Mrs. Cailloux was diagnosed with Alzheimer's and her son became responsible for her affairs.

Six years later, the son, acting on Mrs. Cailloux's behalf sued Baker Botts and Wells Fargo for breach of fiduciary duty in advising her on the disclaimer. A jury found that both had breached their fiduciary duties. A $65.5 million equitable trust, to be funded by Baker Botts and Wells Fargo, was to be established similar to the trust that would have been established for Mrs. Cailloux if she had not made the disclaimer.

The Appellate Court reversed finding that the evidence against Baker Botts and Wells Fargo was insufficient and that the equitable trust was an inappropriate remedy.

X. Remote conflicts may pose big problems.

<u>In re Estate of Fogelman</u>, 3 P.3d 1172 (Ariz. Ct. App. 2000). Personal representative owes duty to beneficiaries of the estate which can conflict with duties to client of personal representative's law firm.

John Fogelman died in 1997, leaving a will naming a number of beneficiaries. The bulk of the value of his estate was in a life insurance policy that passed outside the will directly to named beneficiaries. The will directed the personal representative to pay all estate taxes from the residue of his estate and not to seek reimbursement for taxes incurred on property outside of the probate estate. Upon Fogelman's death, an attorney friend, Richard W. Sheffield, became executor. Sheffield hired his law firm to represent him as personal representative. There were several unsecured creditors of the estate, including Citibank and Bank of America, some of whom were clients of the law firm.

Because the probate estate lacked sufficient assets to pay creditors, the personal representative asked the insurance beneficiaries to pay a portion of the taxes from the life insurance proceeds. Initially, the beneficiaries agreed, but then changed their minds and asked Sheffield to resign. Sheffield at that point filed a petition for instructions.

The trial court found that Sheffield and his law firm had a conflict of interest and that they had violated Ethical Rule 1.7 (explaining an attorney's duty to his client in a conflict of interest situation) and Ethical Rule 2.2 (providing guidance for an attorney who acts as an intermediary between two clients). In addition, the trial court found that Sheffield and his law firm had violated A.R.S. § 14-3703(A) which imposes a fiduciary duty of loyalty

upon a personal fiduciary and the personal representative's attorneys. This was because Sheffield and his law firm failed to disclose that the firm represented some of the estate's creditors. The trial court also found that the personal representative and the law firm acted in bad faith by failing to disclose the conflict of interest. The trial court removed Sheffield as personal representative, disqualified the law firm from further participation in the case, and reduced the law firm's fees from $110,000 to $22,500.

Three issues were raised on appeal:

1. Did Sheffield and the law firm violate the Ethical Rules?

2. Did Sheffield and the law firm violate their statutory fiduciary duty?

3. Did Sheffield and the law firm act in bad faith?

With respect to the ethical rules, the appeals court looked at its holding in Estate of Shano, 869 P.2d 1203 (App. 1993), where it held that a personal representative and his attorney owe a duty of fairness and impartiality to the beneficiaries of an estate. However, an attorney owes a client a higher duty of undeviating and single allegiance. Thus, there was a tension between the personal representative's duties to the estate and to the beneficiaries of the estate. The laws of different states vary as to who is a client. Under one view the client is the fiduciary. Under another view, the client is the estate or trust including the beneficiaries. Here, the court held that because the beneficiaries were not "clients" of either Sheffield or the law firm, Ethical Rules 1.7 and 2.2 had not been violated with respect to the beneficiaries.

With respect to the trial court's holding that Sheffield and the law firm violated the statutory fiduciary duty to the beneficiaries that a personal representative "shall use the authority conferred upon him . . . for the best interests of the successors to the estate," the appellate court agreed that Sheffield and the law firm had breached their duty. Again, relying on Shano, the appellate court held that the personal representatives and the law firm did not owe a duty of loyalty to the beneficiaries (as the trial court had found), but they did owe a duty of fairness and impartiality. Thus, they were required to disclose to the beneficiaries the possible conflict they had because they also represented creditors of the estate. The conflict arose because any money paid by the estate as taxes on the insurance proceeds reduced the funds available to pay creditors from the estate. In other words, if, as Sheffield proposed, the insurance proceeds would pay a pro rata share of the taxes, more funds might be available to the estate and could be used to pay the creditors.

On the bad faith issue, the appellate court believed that Sheffield and the law firm took a correct legal position in seeking payment of part of the taxes from the insurance proceeds. However, the court was concerned that Sheffield and the law firm may have advocated that position to elevate the claims of the unsecured creditors over the rights of the beneficiaries to receive the insurance proceeds. The court remanded the issue to the trial court, noting that a party may assert a correct legal position and still act in bad faith.

Fogelman raises more questions than it answers. For example, how does a personal representative or an attorney fulfill a “lesser” duty of “impartiality” and “fairness” to beneficiaries, without violating its higher duty to the estate? Moreover, if a large law firm, as is the case here, represents numerous clients, such as utilities and banks who might be creditors of a decedent, how does it become aware of the possible conflict, especially if it is not representing the creditor in its matter against the decedent. A conflicts check possibly will not disclose that.

XI. Business Trusts. If it sounds too good to be true, it probably is.

Muhich v. Commissioner, 238 F.3d 860 (7th Cir. 2001), affirming T.C. Memo. 1999-192. Business trusts or similar arrangements held to be sham transactions.

The Muhich case is a recent example of the IRS’s heightened prosecution of trust schemes that in essence promote tax fraud. From time to time, certain lawyers, accountants or financial planning professionals have attempted to market a tax planning technique variously called the common law business organization, contractual business organization, or business trust. The common law business organization is offered as a way to hold an individual’s assets in order to substantially reduce, or eliminate, income taxes, and avoid all gift or estate taxes in transferring these assets to family members at death. It is described as the ultimate estate planning tool. It is, in reality, a sham. It is a sham that builds on some widely accepted concepts, but one that takes the concepts to such an extreme level that some individuals who have marketed common law business organizations have been convicted of selling illegal tax shelters. In many of the schemes involving a common law business organization or business trust, the entity is operated like a holding company to which the grantor transfers virtually all his assets. “Expenses” of the grantor are reimbursed by the trust, with the trust taking a deduction for the expenses and thereby offsetting any income.

In Muhich, the taxpayer transferred his portrait company to trusts in exchange for certificates of beneficial interest. He entered into a consulting contract with the company. The portrait company deducted the consulting fees and claimed other deductions, but Mr. Muhich reported no income from the company. The court denied the deductions and the Muhichs were treated as receiving constructive dividends. The Muhichs were liable for back taxes and accuracy related penalties.

In Notice 97-24, 1997-1 C.B. 409, the IRS announced a special project to examine common law business organizations and business trusts, and to audit and prosecute the owners and promoters of such organizations. Since that time, there have been a significant number of civil and criminal prosecutions. See, e.g., Stokes v. Commissioner, T.C. Memo 1999-204; Alsip v. Commissioner, T.C. Memo 1999-172; Zachman v. Commissioner, T.C. Memo 1999-392, 78 T.C.M. (CCH) 886; Zachman v. Commissioner, T.C. Memo 1999-391, 78 T.C.M. (CCH) 880; George v. Commissioner, T.C. Memo 1999-381, 78 T.C.M. (CCH) 816.

XII. Payment of Estate Tax. The IRS's patience is not infinite.

<u>Hartsell v. Commissioner</u>, T.C. Memo 2004-211 (September 21, 2004). Estate fails to show that failure to pay estate tax on time was due to reasonable cause and not willful neglect.

Antoinette Hartsell died on December 18, 1998 with a gross estate valued in excess of $13 million. The estate consisted of real property, mineral interests, royalty interests, stocks, bonds, and accounts receivable. Over 70% of the value of the taxable estate was attributable to nonliquid assets. Decedent left her entire estate to a friend, Donald Renbarger, and also designated Renbarger as personal representative of the estate.

The original due date for payment of the federal estate tax was September 20, 1999. Renbarger submitted a timely request for an extension of time to pay the federal estate tax under Section 6161 and a partial payment of $100,000 toward a total federal estate tax liability of $4,267,373. The IRS granted the first request for an extension of time to pay through March 16, 2000. The IRS subsequently granted a second timely request for an extension of time to pay through March 18, 2001. Renbarger submitted a third request for an extension of time to pay on March 9, 2001. The IRS asked Renbarger to substantiate reasonable causes for a further extension of the payment due date. Because Renbarger failed to substantiate reasonable causes, the IRS denied the third request for an extension of time to pay. The final payment due date was March 18, 2001.

Renbarger also offered to compromise the estate tax liability of $4,267,373 for $2,166,000. The IRS rejected the offer in compromise after determining that collecting an amount larger than $2,166,000 would not create an economic hardship.

The IRS assessed an addition to the tax owed under Section 6651 and the court held in favor of the IRS, stating that Renbarger did not show that the failure to pay estate tax was due to reasonable cause rather than willful neglect.

First, the court believed that Renbarger failed to seriously pursue financing for the timely payment of tax. Moreover, even though there were 60 parcels of real estate that could be sold, Renbarger chose to sell a mere five properties to satisfy the federal estate tax obligation. He advertised the properties by placing a single "for sale" sign on each property with a phone number. He did not enlist the assistance of a professional real estate broker. In addition, Renbarger made payments of state death taxes to four states while not paying the federal tax.

Failure to pay timely will be considered due to reasonable cause if a taxpayer exercised ordinary business care and prudence and was nevertheless unable (or would suffer an undue hardship) to pay the tax by the due date. To satisfy the undue hardship part of the test, a substantial financial loss would have to result to the estate by making the payment by the due date. If a market exists, the sale of property at the current market price is not ordinarily considered an undue hardship. After considering all the factors, the estate believed that Renbarger had not met the test for showing reasonable cause and that the

estate would not have faced an undue hardship by failing to pay the tax almost two years after the date of decedent's death.

XIII. Life Insurance. An owner must have a good reason for buying life insurance.

Chawla v. TransAmerica Occidental Life Insurance Company, 2006 WL 538993 (4th Cir. 2006). Fourth Circuit vacates portion of decree dealing with whether a trust has an insurable interest.

Harald Geisinger applied for a life insurance policy on May 4, 2000, in the amount of $1,000,000. He named Vera Chawla, the wife of his doctor, as the owner and beneficiary. The insurance company refused to issue the policy naming Chawla as owner and beneficiary because she lacked an insurable interest in the life of Geisinger. Consequently, the proposed owner and beneficiary were changed from Chawla to the Harald Geisinger Special Trust, of which Geisinger and Chawla were the co-trustees. TransAmerica issued the policy to the trust. Interestingly, the trust agreement did not grant the trustees the authorization to procure life insurance on the life of the decedent. There is clear evidence that Geisinger failed to correctly answer various questions on the application for insurance concerning his medical history. Although he had been hospitalized several times for brain surgery and treatment for alcoholism, he only indicated, when asked about hospitalization and medical treatment, a visit to Chawla's husband, an urologist. In September, 2001, Chawla applied to increase the face value of the policy from $1 million to $2.5 million. A medical evaluation form with answers identical to those contained in the original application was submitted.

Geisinger subsequently died on September 23, 2001. Chawla then submitted a claim for benefits which the insurance company denied. The insurance company rescinded the policy and refunded the premiums paid on the grounds that Geisinger failed to disclose certain medical information that was material to the insurance company's decision to issue the policy. Chawla brought a lawsuit for breach of contract in order to recover the proceeds and both parties submitted motions for summary judgment. Although the case was tried in Virginia, the court applied Maryland law since Chawla lived in Maryland at the time the policy was entered into. The district court noted that Geisinger had made significant misrepresentations which resulted in much higher risk of loss for the insurance company and the policy was void for that reason. The district court then went on to say that the policy would also be void because the trust lacked an insurable interest in Geisinger's life.

The court noted that the trust gained more financial benefit upon Geisinger's death than when he was alive and the trust suffered no detriment, financial or otherwise, upon Geisinger's death. Because the trust suffered no detriment and faced no risk of loss, according to the court, it maintained no insurable interest in the life of Geisinger. More importantly, the district court seemed to imply that no trust could have an insurable interest.

On appeal, the Fourth Circuit agreed with the district court's analysis that the policy was void because of the misrepresentations made by Geisinger. The Fourth Circuit vacated

the portion of the decree dealing with an insurable interest. The court indicated that the alternate ruling regarding the insurable interest was unnecessary to resolve the case.

When the district court decision was issued in 2005, some commentators, upon reviewing the decision, believe that the court held that no trust could have an insurable interest. Most commentators, however, believed that the district court's ruling would not affect the common type of irrevocable life insurance trusts. Most such trusts are set up for the benefit of spouses, children, or other family members and, therefore, under the laws of most states, should have an insurable interest, because these individuals have an insurable interest. If a trust does not have a family member as a beneficiary, such as in the case of an unmarried partner, the policy could be at risk of being voided, depending on state law.

Commentators had hoped that the Fourth Circuit would address the issue of whether there was or was not an insurable interest. This did not occur, but at least the Fourth Circuit vacated the part of the decision dealing with an insurable interest.

XIV. Disclaimer. Disclaimers are not done lightly.

A. Walshire v. United States, 288 F.3d 342 (8th Cir. 2002). A disclaimer of property with a reserved life estate is not a qualified disclaimer.

The decedent in this case had been the primary beneficiary of the estate of his deceased brother. He had executed a disclaimer of the remainder interest in his share of the estate, but reserved to himself a life estate in the property. Following the disclaimer, the estate had distributed the decedent's share of the estate to him by checks made jointly payable to him and each of his children, who were the takers in default of his share. The checks were used to purchase certificates of deposit ("CDs"), which were originally held solely in the decedent's name with his children being named as "pay on death" beneficiaries. The decedent received income from the CDs during his life but did not otherwise use or invade the principal balance.

Upon the decedent's death, his executors did not include the value of the CDs in his estate. The IRS asserted the value of the CD's was includable because the disclaimer of the remainder interest was not valid. Under Section 2518, a qualified disclaimer must be an irrevocable refusal to accept an interest in property and must satisfy four other requirements:

There must be a signed written refusal identifying the interest to be disclaimed.

The disclaimer must be made within nine months of the interest creating the transfer.

The disclaimant must not have previously accepted any of the interest or its benefits.

The interest passes to surviving spouse or to person other than disclaimant.

The IRS's position was based on Treas. Reg. § 25.2518-3(b), which provides that a horizontal division of property, as had occurred here, is not a qualified disclaimer of an "interest in property."

The estate contested the validity of the regulation. The Eighth Circuit Court of Appeals found the regulation valid. The court noted that although the statute allows for disclaimer of "any interest in property" this must be read in context of the section of the statute that allows a transferee to disclaim an "undivided portion" of a transferred interest. The court found that an undivided portion of an interest is a portion that does not separate out the bundle of rights associated with the interest being apportioned. For example, if as in this case, a disclaimant is bequeathed a fee interest, an undivided portion of that interest would have to include all the rights associated with the fee, including immediate possession. Here, the decedent disclaimed a remainder interest, which does not include the right to immediate possession. Therefore the remainder interest could not be an undivided portion of the fee given to decedent.

Based on this analysis, the court determined it was reasonable for the IRS in its regulations to determine that a division must be vertical to meet the definition of an undivided portion. The court further noted that the purpose of the disclaimer statute is to avoid a second transfer tax where the intended recipient steps back and allows the property to bypass him. The court found that by retaining the income, the decedent did not step back, but rather benefited from the property during his lifetime.

B. Estate of Engelman v. Commissioner, 121 T.C. 54 (2003). Surviving spouse's disclaimer was ineffective because spouse had previously exercised power of appointment over the assets she sought to disclaim.

In 1990, a husband and wife established a joint revocable living trust. The trust provided that upon the death of the first spouse, the assets were to be allocated entirely to a separate trust, Trust A, except to the extent that the surviving spouse disclaimed assets. The disclaimed assets were to be placed in Trust B. The surviving spouse was given a testamentary general power of appointment over the assets in Trust A which would be effective if the exercise was in writing and specific reference was made to the power. Husband died on December 30, 1997. On February 5, 1998, the wife executed a document, entitled "Power of Appointment," which directed that the property in Trust A be held in trust for the benefit of a third party and then, upon the third party's death, be distributed to various charitable and non-charitable beneficiaries. The wife died on March 6, 1998. On May 11, 1998, the executor of the wife's estate executed a disclaimer of the wife's interest in Trust A in order to take advantage of the husband's applicable exclusion amount. The assets in Trust A were valued at approximately $600,000 as of the husband's date of death.

Several requirements must be met under Section 2518 for a disclaimer to be effective: the disclaimer be made in writing, it be made within nine months after the date of the initial transfer, and, as of result of the disclaimer, the property passes either to the spouse of the decedent or to someone other than the disclaimant. In addition, and the critical

factor in this case, the disclaimant must not have accepted either the property or any of its benefits prior to the disclaimer.

The Tax Court found that the disclaimer by the wife's executor was ineffective because the wife had accepted the benefits of property through her prior exercise of the power of appointment over the assets of Trust A. It cited to the provision of the regulations on disclaimers which states that "the exercise of a power of appointment to any extent by the donee of the power is an acceptance of its benefits." Treas. Reg. § 25.2518-2 (b) (1). The Tax Court rejected the estate's argument that the power of appointment signed by the wife never became effective because the disclaimer subsequently executed by the executor related back to the husband's death on December 30, 1997 and therefore had to be treated as pre-dating the exercise. The court found that as a matter of state law (California in this instance) a disclaimer cannot be made if the beneficiary has accepted the interest to be disclaimed. Consequently, an additional $600,000 was included in the wife's estate and subjected to estate tax. The case illustrates the importance of considering a disclaimer immediately after a decedent's death rather than waiting several months.

XV. Honest Mistakes by the IRS.

<u>Estate of Halder V. Commissioner</u>, T.C. Memo 2003-84. Estate may not take advantage of "honest mistake" by IRS Appeals Officer.

Anita Halder MacDougal, executrix of her mother Dora Halder's estate, filed a petition disputing the IRS' determination of the fair market value of Dora Halder's interest in a limited partnership. The IRS originally valued Dora Halder's interest in the limited partnership at $1,627,960. After negotiations with the IRS Appeals Officer, the estate's accountant prepared a settlement proposal valuing the partnership at $869,000 based on the date of the partnership's formation. The Appeals Officer rejected the settlement offer outright and proposed via telephone a valuation of $1,124,410 based on the value on the decedent's date of death.

Pursuant to his promise, the Appeals Officer sent a fax containing the "chicken scratch" calculations he used to reach the $1,124,410 figure. However, he mistakenly valued the partnership interest at only $1 million. Upon receiving the fax and recognizing the mistake, the estate's accountant contacted the estate's counsel and the executrix to inform them of the offer and its error. The accountant did not notify the Appeals Officer of the discrepancy. Two days later, the accountant accepted the $1 million settlement, also via fax.

The Appeals Officer promptly responded that the $1 million figure was an error and provided revised calculations. In subsequent correspondence, the estate agreed that the figures sent in the original fax were an "honest mistake" but argued that the figure still made sense and that a "basis of settlement had been reached." The Appeals Officer refused to recognize the agreement and did not attempt to receive settlement authorization. The estate then moved for entry of decision.

The Tax Court applied "general principles of contract law" and denied that a basis for settlement existed. In concluding that no "meeting of the minds" had occurred in reaching a settlement—a determination of fact, not law—the court noted that "a prerequisite to the formation of an agreement is an objective manifestation of mutual assent to its essential terms." The estate recognized that the value listed on the fax differed from the value proposed by the Appeals Officer over the telephone, and pursued the advantageous lower value without "requesting clarification" even while acknowledging that the offer was an honest mistake. The court also distinguished prior cases, which argued for restraint in setting aside settlement stipulations, noting that in the instant case the parties failed to reach a settlement agreement or file a stipulation and that the Appeals Officer attempted to correct the error the day after learning of the estate's acceptance of the $1 million figure.

XVI. Section 2035 and the payment of Gift Tax within three years of death.

Brown v. United States, 329 F.3d 664 (9th Cir. 2003). Transfer of funds from husband to wife for wife to pay gift tax is subject to step-transaction doctrine when wife was merely "conduit of funds" and transfer was "end run around Section 2035."

Before his death, Willet Brown gave $3.1 million to his wife to fund an irrevocable life insurance trust holding a policy on his wife's life in her name. The insurance trust was presumably designed to help his wife's heirs to pay estate taxes at her death. Gift tax liability on the gift to the irrevocable life insurance trust was assessed at over $1.4 million. Mr. Brown and his attorney agreed that it was a better actuarial risk for his wife, aged 71, to pay the gift taxes, as Mr. Brown was 87 years old and more likely to die within three years of the gift, an event that would trigger the inclusion of the gift tax actually paid in his taxable estate under Section 2035(c). Mr. Brown transferred the amount of the gift tax into his wife's account. The next day she paid the gift tax, although she was under no legal obligation to use the funds for that purpose. Mr. and Mrs. Brown split the gifts on the gift tax return and were jointly liable for the tax.

Mr. Brown died within three years of the gift. His estate tax return claimed zero tax liability, as the gift tax had been paid by Mrs. Brown and his remaining estate had passed to her in a marital trust eligible for the marital deduction. The IRS disagreed, claiming that in substance the gift tax was paid by Mr. Brown and that the funds were not eligible for the marital deduction as they were intended for the benefit of the beneficiaries of the irrevocable life insurance trust.

The district court applied the "step-transaction" doctrine and found that the series of transactions through which Ms. Brown satisfied the gift tax liability should be treated as an integrated transaction in which Mr. Brown was the taxpayer. As a separate matter, the district court accepted the estate's argument that in light of increased administration

expenses, the estate should be able to increase its administration expense deduction, an argument the IRS did not contest. However, the IRS argued that the marital deduction should be reduced in an amount that corresponded to the increased deduction for estate administration expenses. The district court agreed, but only for those expenses paid out of the marital trust corpus, not the marital trust income.

On appeal, the Ninth Circuit ruled against the estate on both issues. Balancing the step-transaction doctrine against the principle that taxpayers should be able to arrange their own affairs to minimize their taxes, the court found that the transfer of funds to Mr. Brown's wife was more akin to tax evasion than tax avoidance and that his wife was a "mere conduit of the funds." The estate made no argument that the transfer was designed to have any effect other than reducing Mr. Brown's tax liability. Even though his wife was not legally bound to use the transferred funds to pay the gift tax, the court found it improbable that she would not, as the transfer was part of a larger plan that left her the initial beneficiary of her husband's estate.

Further supporting the court's decision to treat the gift tax transfer as a single transfer attributable to Mr. Brown was the clear intent on the part of the estate to avoid Section 2035, under which Mr. Brown risked having the gift-tax payment included in his estate should he die within three years of the gift. However, the court also recognized that under Section 2513(d) Ms. Brown was jointly liable to pay the gift tax liability. The estate argued that given this joint liability, the source of funds Ms. Brown used to pay the tax was irrelevant. The court disagreed in light of the clear statutory language of Section 2035 (which requires a grantor to include in his estate any taxes "paid . . . on any gift made by the decedent or his spouse") and its purpose ("to reverse the effect of funds transferred out of an estate within three years of death"). The court concluded that "[h]ere, however, [Mr. Brown] actually supplied the funds, and [his wife's] involvement was merely a 'contrived step' to secure tax treatment different from that which would have resulted if [he] had paid the IRS directly . . . [t]hat contrived step did not alter the economic reality that [he] paid the tax, and [her] transient ownership over the funds for one day had no independent purpose or effect beyond the attempt to alter tax liabilities."

The court next addressed the estate's effort to increase the administration expenses deduction without affecting the marital deduction. Reviewing Section 2056(a), the Ninth Circuit held that "[w]hen administration funds are paid out of funds otherwise earmarked for the corpus of the marital trust, the interplay between the administration deduction and the marital deduction is clear: the larger the administration deduction, the smaller the marital deduction . . . [t]his is so because funds diverted from the marital trust to pay administration expenses do not "pass" to the surviving spouse."

The estate made (and lost) two arguments for maintaining the marital deduction. The estate unsuccessfully argued that the administration expenses should be valued at two different times (calculating the net estate based on the date-of-death value of expenses and the Section 2053(a)(2) deduction based on a contemporaneous valuation). Relying on Estate of Hubert, 520 U.S. 93 (1997), the Ninth Circuit held that the valuation date must be the same when it affects both the value of the gross estate and various deductions. The court also rejected the estate's argument that Hubert supported

increasing the administrative expense deduction without decreasing the marital deduction. The court noted that despite wide dissent in the holding of Hubert, the majority of the Supreme Court justices agreed (in dicta) that administration expenses paid by the marital trust corpus required a pro tanto reduction of the marital deduction.

XVII. Complying with the generation-skipping tax provisions continues to baffle tax preparers.

Letter Ruling 201750014 (December 15, 2017). Extension of time granted to sever a marital trust into exempt and non-exempt trust and to make a reverse QTIP election.

The decedent's will provided for the creation of a bypass trust and a marital trust at his death. The marital trust qualified for QTIP treatment. Upon decedent's death, the personal representative retained an accountant to prepare the Form 706. On Schedule M of the Form 706, the personal representative made the QTIP election with respect to the marital trust. However, the accountant failed to advise the personal representative to divide the marital trust into exempt and non-exempt marital trusts and to make a reverse QTIP election in order to allocate decedent's remaining GST exemption to the exempt marital trust.

The personal representative's error was discovered when the surviving spouse hired a second attorney to plan her estate. Consequently, an extension of time was requested to sever the marital trust into a GST exempt marital trust and a non-exempt marital trust and to make a reverse QTIP election to allocate decedent's remaining GST exemption to the exempt marital trust.

The IRS granted the request for an extension of time. Under Treas. Reg. § 301.9100-3, an extension of time will be granted when the taxpayer can establish that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith when the taxpayer reasonably relied on a qualified tax professional to make an election. The requirements for this regulation were satisfied in this case. Decedent's estate was granted an extension of time to sever the marital trust into exempt and non-exempt marital trusts and to make a reverse QTIP election with respect to the exempt marital trust. In addition, the automatic allocation rules of Section 2632(e) would apply to automatically allocate the unused GST exemption to the exempt marital trust.

Letter Ruling 200703002 (January 19, 2007). IRS grants extension of time to have automatic allocation of GST Exemption rules not apply to transfers to trusts.

The 2001 Tax Act expanded the automatic allocation rules for the GST exemption beyond direct skips. Section 2632(c) now provides for an automatic allocation of an individual's GST exemption to a lifetime "indirect skip." "Indirect skip" means any transfer of property (other than a direct skip) made to a "GST Trust." A GST Trust is defined to include any trust in which there is a significant likelihood that a GST tax ultimately will be owed as a result of a taxable termination or taxable distribution, as

determined by the objective tests set forth in the statute. The statutory definition catches many trusts that are not intended to be generation skipping trusts. For example, consider a typical irrevocable insurance trust for a spouse and children in which the insurance proceeds will stay in trust for the spouse's life and, at the spouse's death, be divided into separate trusts for the children with withdrawal rights at ages 30, 35, and 40. Unless the children are already over the age of 30 at the time of the transfer, this trust is considered a GST trust under Section 2632(c).

As with the automatic allocation rule for direct skips, an individual can elect out of the automatic allocation of GST exemption to an indirect skip. Under the 2001 Tax Act, this was to be done on a timely filed gift tax return or at such later time as permitted by the regulations. Given the expansive definition of the GST Trust, the election out of the automatic allocation rules is quite important. It is also possible to "opt in" and to treat a trust as a GST Trust. The regulations provide that the filing of the gift tax return should be used to make a contemplated election, even if a gift tax return is not otherwise required for the year. In addition, the regulations provide that an election out of the automatic allocation rule does not preclude a specific allocation of GST exemption on a gift tax return in the usual way. An opt out or opt in election can be made either for the year of the gift tax return or for that year and all future years. An election that also applies to future years can be terminated on a subsequent gift tax return.

In this letter ruling, a taxpayer created an irrevocable life insurance trust and irrevocable trusts for his son and daughter. Under the terms of the insurance trust, there was a possibility that the trust would be considered a GST Trust within the meaning of Section 2632(c). The taxpayer did not intend to allocate any GST exemption to the transfers to the insurance trust. In preparing the gift tax return for the insurance trust, the tax adviser inadvertently failed to elect to have the automatic allocation rules not apply to transfers to the insurance trust. With respect to the insurance trust, the taxpayer was requesting an extension of time pursuant to Treas. Reg. § 301.9100-3 to make the election to have the automatic allocation rules not apply to transfers to the insurance trust.

With respect to the trusts created for the son and the daughter, there was a possibility that they might be subject to GST tax. These trusts did not meet the definition of a "GST trust" and therefore, because GST exemption was not automatically allocated to these trusts, in order to exempt the trust from generation-skipping tax, the taxpayer would have to specifically allocate GST exemption on the gift tax return. Taxpayer's tax adviser had failed to file a gift tax return to allocate GST exemption to the son's trust and the daughter's trust. The taxpayer was also seeking an extension of time to allocate exemption to the son's trust and the daughter's trust as of the date of the transfer.

Under Treas. Reg. §§ 301.9100-1 and 301.9100-3, the IRS can grant a reasonable extension of time when it can be established that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. One example of acting reasonably is when a taxpayer relied on a qualified tax professional and the tax professional failed to make or advise a taxpayer to make an election. The IRS concluded the requirements of the regulations had been satisfied here. Thus, with respect to the irrevocable life insurance trust, the taxpayer would be permitted

to make a late election to opt out of the automatic allocation rules. With respect to the son's trust and the daughter's trust, the taxpayer was given permission to make a late allocation of GST exemption as of the date of the transfer.

This ruling demonstrates the extraordinary care that must be taken in dealing with the automatic allocation rules. The situation here was especially complicated because the automatic allocation rules applied to the trust to which the taxpayer did not want to allocate GST exemption and did not apply to the trusts to which the taxpayer wanted to allocate GST exemption.

XVIII. Ignorance is not bliss for the generation-skipping tax.

Hobbs Jr. v. Legg Mason Investment Counsel and Trust Company, 2011 U.S. Dist. Lexis 999 (January 5, 2011), clarified upon motion for reconsideration, 2011 U.S. Dist. Lexis 7168 (N.D. Miss. January 25, 2011). Plaintiffs are allowed to bring claim based upon failure to inform beneficiaries of generation-skipping tax consequences but lose summary judgment action with respect to alleged damages due to emotional distress and having to sell securities at a loss to pay taxes all based on trustee's failure to inform beneficiaries of GST consequences of distributions from trust.

Upon the death of Edward H. Johnson in 1994, a QTIP marital trust was established for the benefit of his wife, Bernice. Lawrence Glover and First American Trust Company were appointed as co-trustees. The trustees allocated the assets of the marital trust into two separate trusts to take advantage of Edward Johnson's remaining GST exemption. One contained $949,626 of assets exempt from GST tax liability. The other contained $18,420,895 of non-exempt assets.

Bernice Johnson died in January, 1998. Upon her death, the assets of the marital trust were used to fund two charitable trusts. One charitable trust was comprised of GST exempt assets and one was comprised of non-exempt assets. The charitable trusts had eight original non-charitable income beneficiaries and three charitable remainder beneficiaries. The eight original income beneficiaries were the nieces and nephews of Edward and Bernice Johnson. The original beneficiaries would be considered non-skip people and consequently distributions to them would not be subject to GST tax. The charitable trusts lasted ten years during which time the income beneficiaries received distributions. After ten years, the charitable trusts terminated and all assets were to pass to the charitable remaindermen. In 2001, Legg Mason replaced First American Trust Company as a co-trustee.

In January, 2004, one of the eight nieces and nephews of Peggy Groves died. Under the terms of the trust, her two children became the income beneficiaries for the remainder of the terms of each trust. Accordingly, they received distributions during tax years from 2004 through 2008 as "skip beneficiaries." The distributions from the non-exempt trusts were subject to GST liability.

On March 3, 2008 (after the termination of the charitable trusts), Legg Mason advised the two beneficiaries that certain distributions were subject to GST tax. This was the first

time that Legg Mason advised the two beneficiaries (who became the plaintiffs) of any tax liability attached to the distributions. Legg Mason had not realized that during the term of the trust GST taxes would be owed. In the case of a taxable distribution, Section 2603(a)(1) states that the GST tax is to be paid by the transferee.

Plaintiffs owed back taxes and interest on their distributions from the non-exempt trust. In order to pay the amount owed, plaintiffs had to obtain a line of credit secured by assets in a separate trust established by their mother. Each owed a GST tax of approximately $434,840 and interest of approximately $69,000.

In 2009, plaintiffs filed a complaint alleging breach of fiduciary duty and negligence. In its first decision in this summary judgment proceeding, the court rejected three of the plaintiffs' four contentions. Plaintiffs argued that Legg Mason had a duty to modify the trust to minimize GST tax liability. However, the court found that the Tennessee Uniform Trust Code, which governed this situation, provided that while a trustee has the power to seek a modification of the trust, it has no duty to do so.

It next rejected the plaintiffs' claim for alleged losses incurred upon the sale of stock to repay the line of credit incurred to pay the tax liability. The court did so because the plaintiffs failed to show that their stock liquidation loss was reasonably certain.

The court then rejected one of the plaintiffs' claims for emotional damages. It said that emotional damages may only be granted in situations where the injury is inspired by fraud, malice, or like motives. Because the plaintiff failed to assert any fraud, malice, or like motives, this contention was rejected.

Finally, the court rejected the application of any punitive damages on a summary judgment basis because plaintiffs did not allege any intentional, fraudulent, or malicious acts by Legg Mason. To recover punitive damages, plaintiffs must offer evidence that defendants acted recklessly. This would have to be decided at trial

As a result, the court in its first decision on January 5, 2011 granted Legg Mason's motion for partial summary judgment as to the claim for GST tax liability, stock liquidation losses, and emotional damages and deferred ruling on the motion as to plaintiffs' claim for punitive damages since evidence was not yet presented.

Upon a motion for reconsideration of the court's grant of partial summary judgment, the court stated that it erred in assuming that modification of the trust was the only theory of liability with respect to the GST tax liability. The court noted that the plaintiffs had also alleged that the trustees breached their fiduciary duties by failing to notify plaintiffs of the tax consequences of the distributions and failing to notify plaintiffs of several issues with respect to their GST tax liability. It noted that Tennessee law requires a trustee "to keep the beneficiaries reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests." For that reason, the plaintiffs could bring their action upon based upon the alleged failure of the trustees to keep them informed.

XIX. Executors are responsible for filing on time.

<u>Estate of Zlotowski v. Commissioner</u>, T.C. Memo 2007-203. Tax Court rules that executors of an estate were liable for the additional tax for failure to timely file the Form 706 because they failed to show that the failure to file was on account of reasonable cause and not due to willful neglect.

Decedent died on September 10, 1999. At the time of her death, although a U.S. citizen, she was domiciled in Germany and had made two wills, one U.S. will and a later German will which revoked the U.S. will. In ignorance of the German will, the two individuals nominated in the U.S. will as executors presented the U.S. will for probate in the New York Surrogate's Court and were granted preliminary letters testamentary. They were represented by an attorney in administering the estate who was chosen by the decedent's attorney. Only after the preliminary letters testamentary were granted by the New York Surrogate's Court did the estate's U.S. attorney learn about the German will.

The original due date for the federal estate tax return was June 12, 2000. The executors requested and received an extension to file the return until December 10, 2000. However, the executors did not file the estate tax return until September 19, 2001. The IRS assessed the penalty under Section 6651(a)(1) for failure to file the estate tax return on time. By the time this reached the Tax Court, one of the two U.S. executors had died. The remaining U.S. executor testified that he was 85 years old and that he was nominated as an executor because he was close to decedent's husband with whom he had done business. He knew nothing about the estate and relied fully on the attorneys to handle the filing of the estate tax return. He had signed the estate tax return on August 28, 2001. He never discussed with the attorney penalties for a late filed return. When asked whether the attorney had ever discussed with him whether the estate tax return was going to be filed on time, the executor answered "Well, they mentioned it to me at one time that they were a little late in the filing, and that they took care of it, and that they would file it a little later."

Section 6651(a)(1) provides for additional tax to be paid in the event that a return is not filed timely unless it can be shown that the failure was due to reasonable cause and not due to willful neglect. The amount of the additional is equal to 5% of the amount required to be shown as tax on the delinquent return for each month or fraction of a month during which the return remained unfilled, up to a maximum addition of 25% for returns for more than four months delinquent.

The IRS did not contend that the return was delinquent because of the executor's willful neglect. Instead, the IRS stated that the executors failed to establish reasonable cause for the failure to file the return on time. The executor argued that he had reasonable cause because "it was abundantly clear that the executors relied on the advice of their attorney not to file at the time the return was due." Apparently, the reason for failing to file the return on time (within the extension period) was because the beneficiaries of the German will had raised questions.

The Tax Court held in favor of the IRS. There was testimony at trial that the attorney had advised the executors in September or October of 2000 not to file an estate tax return because of the possible claim by the German heirs, which might have shown reasonable cause. However, the remaining executor did not testify that either he or the other executor even received or understood that advice. Thus, the court found that the executor had not shown that the failure to file the return timely was due to their reliance on the advice received from the attorney. As a result, the estate would be liable for the additional tax owed pursuant to Section 6651(a)(1) for failure to file the return timely.

Estate of Liftin v. United States, 111 Fed. Cl. 13 (2013). Estate is not entitled to refund of a late filing penalty because it lacked reasonable cause for waiting nine months to file the estate tax return once a marital deduction issue involving a non-citizen spouse was addressed.

Morton Liftin died on March 2, 2003, and appointed his son, John, as the executor. Morton's spouse, Anna, was a citizen of Bolivia when Morton died. Anna was a beneficiary of the estate and also asserted claims against the estate arising out of her rights under a prenuptial agreement.

The estate was required to file the federal estate tax return by December 2, 2003. John hired a former law partner to assist with the preparation of the federal estate tax return and the administration of the assets. The estate could not claim a marital deduction for the amounts passing to Anna unless Anna was a U.S. citizen.

On November 26, 2003, the estate requested a six-month extension of time to file the return and pay the taxes due. The IRS granted the estate's request for an extension of time to file and pay, setting a new deadline of June 2, 2004. On January 20, 2004, the estate made a payment of $877,300, which the estate estimated would be sufficient to satisfy the taxes due even if it was unable to claim the marital deduction. John and the attorney became aware that Anna intended to apply for U.S. citizenship, but that the naturalization process might not be completed before the June 2, 2004, deadline. The attorney advised the estate, in substance, that a late filing after June 2, 2004, in order to claim the marital deduction would not trigger a penalty as long as the return was filed within a reasonable time after Anna became a U.S. citizen. John found this advice to be reasonable since the estate had paid more than the amount of tax that the executor believed would ultimately be due. After the June 2, 2004, deadline for filing the return passed, the IRS, on October 4, 2004, wrote the estate inquiring why it had not filed the tax return. The attorney responded on November 4, 2004, setting forth the estate's position.

On August 3, 2005, Anna became a U.S. citizen. In February 2006, the estate and Anna settled her claims against the estate.

On May 9, 2006, the estate filed the estate tax return claiming the marital deduction. The tax return showed a tax due of $678,572 and an over payment of $198,727. The IRS did not contest the marital deduction, but on June 12, 2006, issued a notice of adjustment reflecting a $169,643 penalty for late filing and late payment pursuant to

Sections 6651(a)(1) and 6651(a)(2). The estate filed a refund claim with the IRS and the IRS granted a partial refund of $33,928.61.

The estate and the IRS moved for summary judgment on the remaining amount which the IRS claimed was due.

Section 6651(a)(1) imposes a penalty for failure to file a required return before the statutory or extended deadline unless the taxpayer can establish that such failure was due to reasonable cause and not willful neglect. The court found that the estate's failure to file its estate tax return during the fourteen months after the extended deadline, but before Anna became a U.S. citizen was due to reasonable cause and not willful neglect. However, once Anna was naturalized, the estate waited an additional nine months to file its estate tax return. The IRS argued that this exceeded a reasonable amount of time.

The estate argued that the attorney had advised the estate that it could delay filing until it could submit an accurate return, which in turn depended upon the resolution of Anna's claims against the estate. The court found that this was not an interpretation of substantive tax law and the estate could not rely upon it. Instead, it found that the addition to tax penalty for failure to file timely reaches the statutory maximum if the delinquency continues longer than four months. Consequently, the estate's nine month delay after Anna became a U.S. citizen without reasonable cause was sufficient to subject the estate to the maximum late filing penalty. It also noted that an estate has an obligation to file a timely return with the best available information and cannot claim reasonable cause based on advice that it was necessary to wait for complete information before filing a return. The court cited Estate of Young v. United States, ___ F. Supp. 2d (D. Mass. 2012) and Russell v. Commissioner, 101 T.C.M. (CCH) 1363 (2011).

XX. The strangest things happen with trust protectors.

Wyly v. United States, 2014 U.S. Dist. LEXIS 135671 (September 24, 2014). Court holds that imputed actual control, but not legal control, over offshore trusts causes offshore trusts to be subject to grantor trust rules which in turn required reporting to Securities and Exchange Commission.

In a civil enforcement action against Samuel Wyly and the estate of his brother, Charles Wyly, the Securities and Exchange Commission (SEC) alleged ten securities violations arising from tax planning in which the Wylys established a group of offshore trusts and subsidiary entities in the Isle of Man, used those offshore entities to trade in the shares of four public companies on whose boards the Wylys sat, and failed to properly disclose their beneficial ownership of that stock. The liabilities and remedies phases of the trial were split. In a jury trial on liability on nine of the ten claims, the jury returned a verdict against both Sam and Charles Wyly on all nine claims. This decision in this case was in the subsequent remedies phase. The SEC sought an order of disgorgement against the Wylys in the amount of $619,298,512.45. This figure included the amount of taxes that the Wylys avoided when the stock in the Isle of Man trusts was sold. The SEC also sought a civil penalty and injunctive relief.

Between 1992 and 1996, Sam and Charles Wyly created a number of Isle of Man trusts which were treated as separate entities for income tax purposes and were intended to avoid U.S. income taxation. The Wylys' family attorney, the Chief Financial Officer of the Wyly Family Office, and the CFO of a related trust company served as the protectors of the Isle of Man trusts. The trust protectors conveyed the Wylys' investment recommendations to the trust management companies administering the Isle of Man trusts. All the investment transactions were based on the Wylys' recommendations and the Isle of Man trustees never declined to follow a Wyly recommendation.

Between 1992 and 1999, Sam and Charles Wyly sold or transferred to the Isle of Man trusts or companies, stock options in four publicly traded entities in exchange for private annuities while simultaneously disclaiming beneficial ownership over the securities thereby claiming there was no need for public filings with the SEC with respect to the four companies. Between 1995 and 2005, the Isle of Man trusts and companies exercised these options and warrants, separately acquired options and stock in all four companies, and sold the shares without filing disclosures with the SEC.

The offshore system was created with the advice of a Louisiana lawyer who lectured extensively on the use of foreign trusts as a method of asset protection and tax deferral. According to the court, the Wylys wished to avoid any disclosure of their control of the stocks in order to maintain the tax free status of these trusts, including income from transactions in the securities of the four public companies. The court noted that it was logical to draw the inference that making misleading statements in SEC filings, or not making SEC filings at all, was part of the Wylys' plan to maintain the appearance of their separation and independence from the foreign trusts.

The offshore trusts were explicitly set up as non-grantor trusts. Under the terms of the trusts to avoid U.S. income taxation, no United States beneficiary could receive a distribution from the trusts until two years after the death of the respective settlors. However, the SEC argued that the Isle of Man trusts were grantor trusts under Section 674(a) because the Wylys retained the ability to affect the beneficial enjoyment of the trusts. The SEC also argued that the Isle of Man trusts were foreign trusts under Section 679 because the transfer of property to the trusts was not made for fair market value.

The trusts were administered by professional asset management companies located in the Isle of Man. The trustees were selected by the Wylys or the trust protectors. The protectors, all of whom the court saw as agents of the Wylys, had the authority to remove and replace trustees. The protectors also transmitted the Wylys' investment recommendations to the trustees. The Wylys presented no evidence of an investment made by the Isle of Man trusts that did not originate with the Wylys' recommendations. No Isle of Man trustee rejected a Wyly recommendation. There were also several transactions in which the Wylys bypassed the trustees all together. Some of the Wylys' recommendations had nothing to do with the securities. Among the many personal purchases, loans, and investments the Wylys directed the Isle of Man trustees to make, were business as for Wyly children and family members, real estate, artwork, jewelry, and collectibles.

The court found that the Wylys, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees. Thus, Section 674(a) applied to make the Isle of Man trusts grantor trusts. The Wylys tried to argue that the trust fell within the shelter of the independent trustee exception of Section 674(c). The court disagreed finding that the trustees were not independent. As a result, because the Wylys and their family members were beneficiaries, the Isle of Man trustees were distributing income for the benefit of the beneficiaries at the direction of the grantors and Section 674 applied. Consequently, the Wylys owed income taxes from the trading profits on the sale of the securities. The court declined to tax those sales at the ordinary income tax rate. Instead the court applied either the ordinary income tax rate or the capital gains tax rate for the appropriate year and transaction. This resulted in disgorgement of approximately $112 million for Sam Wyly and $59 million for Charles Wyly.

In making this determination that the Isle of Man trusts were grantor trusts under Section 674, the court disagreed that the Wylys did not share in the power to distribute, apportion or allocate income or corpus because under the trust documents those powers fell solely to the trustees. Instead, the court noted that "such a rigid construction is unwarranted." It could not be squared with a black letter principle that "tax law deals with economic realities, not legal abstractions." It then cited Professor Robert Danforth, the defendant's expert, who wrote in a treatise "it would certainly violate the purpose of the independent trustee rule to require an independent trustee to act with the consent of the grantor or a related or subordinate person." The court then noted that the Wylys, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees. The Wylys expected that the trustees would execute their wishes and the trustees did exactly that.

This is a case in which there are bad facts. This case does show that a court might attribute the powers of the trustees or the trust protectors to the grantor if sufficient distance is not maintained.

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Activity Information	
Program Name:	17th Annual Estate Planning for Professionals
Sponsor:	SECURITY NATIONAL BANK OF SIOUX CITY
Start Date:	09/18/2019
End Date:	09/18/2019
City:	South Sioux City
Class Type:	Standard(live)
Total CLE Hours Approved:	4.0
Ethics Hours Approved:	1.0
Activity Number:	333899

This approval means that time spent in continuing legal education activities incorporated in this accredited program may be credited against the continuing legal education requirement of fifteen (15) clock hours per year, established by Rules 41.3 and 42.2 of the Iowa Supreme Court.

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Program Name:	The Security National Bank of Sioux City Estate Planning Update
Sponsor:	Security National Bank, Iowa
Start Date:	09/18/2019
End Date:	09/18/2019
City:	South Sioux City
Class Type:	Regular/Traditional
Total CLE Hours Approved:	4.0 (If you submitted this for Professional Responsibility credits, those are approved only as shown below)
Professional Responsibility Hours Approved:	1.0
Activity Number:	180571

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