BESSEMER TRUST

LOOKING AHEAD – Estate Planning in 2024 & Current Developments (Including Observations from Heckerling 2024)

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Introduction

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

1. Summary of Top Developments in 2023

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

(1) Thorough discussion of valuation approaches, tax affecting, and appropriate lack-of-marketability and lack-of-control discounts regarding the famous, closely-held, Biltmore Company (*Estate of Cecil*) (see Item 25 below);

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

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

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

(5) Estate tax treatment of life insurance owned by a closely-held company, and a buy-sell agreement that failed the §2703(b) tests (*Connelly v. United States*, cert granted 12/13/2023) (see Item 28 below);

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

(7) Creative, but questionable and troublesome, extension of personal estate tax liability to beneficiaries and a successor trustee of a revocable trust who received trust assets and trust distributions after the decedent's death (*United States v. Paulson* 9th Cir.) (see Item 27 below);

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

(9) IRS rejects decanting of QTIP trusts to permit charitable distributions at the spouse's death, but folds when Tax Court pushes back (*Estate of Horvitz*) (see Item 24 below); and

(10) Gift to charity followed quickly by a sale triggers the anticipatory assignment of income doctrine to deny a charitable deduction (*Hoensheid*) (see Item 26 below).

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

2. Trending in 2024

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

b. **Transfer Planning to Utilize "Bonus Exclusion."** Will the exclusion amount decrease to $5 million (indexed) in 2026? No one knows; the answer depends on what Congress does in 2025 (which will depend, in part, on the November 2024 elections). Some commentators say "no serious planner is predicting … the [$10 million (indexed)] basic exclusion amount … will be preserved." Redd, *Emerging Topics and Trends to Follow*, TRUSTS & ESTATES at 7 (Jan. 2024). Others are just as adamant the large exclusion amount will be extended by Congress (some saying the exclusion

amount has never gone down before, which is not exactly true, see Item 3.c below). At a minimum, though, there is a significant chance that Congress will not act to prevent the exclusion amount from going down in 2026. Clients may want to take advantage of the difference (the "bonus exclusion") in case the exclusion amount drops in 2026 (from over $14 million to over $7 million). To make use of the "bonus" amount, the client must make a gift of well over $7 million; for example if an individual makes a gift of about $7 million in 2024 and if the exclusion amount goes down to about $7 million in 2026, the individual will have simply used up his or her $7 million amount and will have made no use of the "bonus" amount. For individuals with over about $30 million or couples with over about $60 million, they may (with an emphasis on "may") be able comfortably to afford making transfers of the exclusion amount, but clients having less than that will likely want to retain ways to keep some type of retained cash flow from or discretionary access to the transferred assets. Or a couple may want just one spouse to make a gift to utilize his or her bonus exclusion amount.

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

(2) **Spousal Lifetime Access Trust (SLAT).** One alternative may be for one spouse to make a gift to a trust for descendants, but of which the other spouse is a discretionary beneficiary. If the proverbial "rainy day" hits, distributions could be made to the spouse-beneficiary. The planner must be very sensitive to matrimonial law issues (the SLAT transaction can result in a very substantial wealth shift between the spouses.) Also, the transfer must be made entirely from one spouse's property to the trust of which the other spouse is a discretionary beneficiary. For further discussion about SLAT planning, see Item 11.j below.

(3) **Other Transfers With Continued Possible Indirect Access.** Couples making gifts of a large portion of their $13.61 million (in 2024) basic exclusion amount may want potential access to or potential cash flow from the transferred funds. Various planning alternatives for providing some potential benefit or continued payments to the grantor and/or the grantor's spouse are discussed in more detail in Items 14-25 of the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** Also, a preferred partnership freeze strategy is discussed in Item 3.q. of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

(5) **Sales to Grantor Trusts.** Gifts to grantor trusts followed by sales of assets to the trust continues to be a powerful wealth transfer planning tool. GST exemption can be allocated to the gift, so the trust is GST-tax-exempt, including all appreciation from the assets sold to the trust. See Item 11.i below. For a general discussion of sales to grantor trusts, see Aucutt, *Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts* (September 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

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

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

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

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

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

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

f. **Decanting and Trust Modification; Governing Law Issues.** Modification of trusts by decanting, nonjudicial modification, or judicial modification transactions continues to be a growing trend to accommodate changing circumstances. Planners have traditionally been very sensitive to the GST tax

effects of modifications, but a trend is that planners will be more sensitive to gift tax issues for consenting beneficiaries. Item 7 below discusses CCA 202352018 in which the IRS took the position that consent by beneficiaries to a judicial trust modification to add a discretionary power of the trustee to reimburse the grantor for the income tax paid with respect to grantor trust income constituted a gift by the consenting beneficiaries. See Item 7 below for a discussion of CCA 202352018 and resulting planning considerations.

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

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

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

h. **Directed Trusts.** The use of directed trusts continues to grow in popularity. The settlor can designate certain persons (or entities) to be responsible for investment decisions (generally or for specific assets) and to make distribution decisions (generally or for certain special distributions). See Item 21 below.

3. Legislative Developments

a. **FY 2025, FY 2024, and FY 2023 Greenbooks.** Tax legislative proposals from the Biden Administration were summarized in "General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals" (popularly called the "Greenbook"), released March 1 2024 (see **https://home.treasury.gov/system/files/131/General-Explanations-FY2025.pdf**), are very similar to the transfer tax and trust provisions in the FY 2024 (FY24) Greenbook. . Many of the provisions of the FY24 Greenbook were similar to items in the FY 2023 and FY 2022 Greenbooks, but the FY24 Greenbook included some rather surprising new transfer tax and trust proposals. For a brief description of some of the business, individual, and transfer tax provisions in the FY23 Greenbook, see Item 2.e of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found **here,** and for a much more detailed discussion of the FY23-FY25 Greenbooks, see Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (March 2024) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** The following is a brief overview of highlights of the FY23-FY25 Greenbooks (the new proposals in the FY24 Greenbook are noted). The FY25 Greenbook is very similar to the FY24 Greenbook with respect to the issues described below, except as noted otherwise.

The FY25 Greenbook proposals have precious **little chance of being enacted** into law with a split Congress. Ron Aucutt warns "[e]ven so, whenever we see legislative proposals articulated like this, it is important to pay attention, because they are constantly evolving and could be pulled from the

shelf and enacted, if not this year then in the future when the political climate is different. Such proposals never completely go away. And each time they are refined and updated, we can learn more about what to watch for and how to react."

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

- Increase the corporate income tax rate from 21% to 28%
- The FY25 Greenbook would increase the corporate alternative minimum tax rate from 15 to 21 percent
- Increase the corporate stock repurchase excise tax from 1% to 4% (in FY24 Greenbook) (and the FY25 Greenbook would close a loophole regarding foreign corporations)
- Reduce basis shifting using partnerships

(2) **Taxation of Individuals.**

- Increase the top marginal income tax rate from 37% to 39.6%
- Tax the capital income for high-income earners (taxable income over $1 million, $500,000 for married filing separately, both indexed) at ordinary rates
- The net investment income tax rate would increase from 3.8% to 5.0% for taxpayers with more than $400,000 of earnings (indexed) (new in FY24 Greenbook) and the net investment income tax would be applied to pass-through business income for high income taxpayers (in the FY23 and FY24 Greenbooks)
- The 39.6% top marginal income tax rate and the 5% net investment income tax rate bring the top marginal rate to 44.6%
- The Medicare tax would increase from 3.8% to 5.0% for taxpayers with more than $400,000 of earnings (indexed) (new in FY24 Greenbook)
- Treat transfers of appreciated property by gift or on death as realization events; gain on unrealized appreciation also would be recognized by every trust, partnership, or other non-corporate entity if the property has been held on or after January 1, 1942 and has not been the subject of a recognition event within 90 years; the FY24 Greenbook clarifies that the first such deemed recognition event would occur on December 31, 2032, and the FY25 Greenbook adds that a tacking rule would apply for the deemed recognition by trusts and non-corporate entities
- Impose a 25% (up from 20% in the FY23 Greenbook) minimum tax on the income (generally including unrealized gains) on wealthiest taxpayers (similar to what has been referred to as the "Billionaire Income Tax" proposals; Senator Wyden introduced the "Billionaires Income Tax Act" (S. 3367, weighing in at 116 pages!) on November 30, 2023, which would annually tax the value of unrealized gains on assets using mark-to-market taxation for taxpayers with adjusted gross incomes of more than $100 million or assets valued at more than $1 billion, *see* Sword & Wallace, *Mark-to-Market Bill Would End 'Buy, Borrow, Die,' Senator Says*, 181 TAX NOTES FEDERAL 1861 (Dec. 4, 2023)); for a discussion of these similar proposals see Item 2.l and 2.m of Estate Planning Current Developments and Hot Topics 2022 (December 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.
    - OBSERVATION: Bills were introduced in the House and Senate on March 19, 2024, titled the "Ultra-Millionaire Tax Act of 2024" that would impose a 2% annual tax on the net worth of households and trusts between $50 million and $1 billion and a 3% annual tax on the excess value above $1 billion.
- Tax "carried interests" as ordinary income if the partner's taxable income exceeds $400,000 (not indexed)

- Eliminate real estate like-kind exchanges for gains in excess of $500,000 ($1 million for joint returns) (not indexed)

(3) **Transfer Tax and Trust Proposals in FY23 Greenbook and Continued in FY24 and FY25 Greenbooks.**

- Add additional restrictions on GRATs (including a 10-year minimum term and a 25% remainder interest-which would effectively kill the use of GRATs going forward)
- Recognize gain on sale transactions between deemed owners and grantor trusts grantor trusts (with an effective date for *transactions* after the date of enactment), with a refinement in the FY24 and FY25 Greenbooks that would disallow losses in such transactions
- Treat the payment of income tax by the grantor on grantor trust income as a gift (effective for trusts created after the date of enactment) (with refinements in the FY24 and FY25 Greenbooks)
    - OBSERVATION: S.3988, the "Getting Rid of Abusive Trusts Act (the "GRATs Act") was introduced on March 20, 2024, by Senate Finance Committee Chair Ron Wyden (D.-Ore) and Sen. Angus King, Jr. (I-Maine) on March 20, 2024. It would implement those first three items regarding GRATs (applicable to trusts created on or after and the portion of trusts attributable to contributions on or after the date of enactment), sales between deemed owners and grantor trusts (applicable to transfers after the date of enactment), and the grantor's payment of income tax on grantor trust income (applicable to trusts created on or after the date of enactment).
- Provide consistent valuation of promissory notes at death
- Limit the duration of GST exemption (distributions to generations younger than grandchildren or persons alive on the date of creation would be subject to the GST tax, and existing trusts would be treated as being created on the date of enactment)
- Expand the definition of executor for all tax purposes (an example of the significance of this proposal is *Sander v. Commissioner*, T.C. Memo. 2022-103, which held that the trustee of the decedent's revocable trust was not a proper party to contest assessed income tax deficiencies of the decedent)
- Increase the special use valuation value reduction from $750,000 (indexed) to $11.7 million ($14 million in the FY 25 Greenbook, up from $13 million in the FY24 Greenbook)
- Extend the 10-year estate and gift tax lien during any deferral or installment period
- Require reporting (not specified as to how detailed the reporting will be) of the estimated value of trust assets for trusts valued over $300,000 or with gross income over $10,000 (the FY24 Greenbook adds that both of these amounts are indexed after 2024, changed to 2025 in the FY25 Greenbook); The FY24 Greenbook adds that each trust would have to report on its annual income tax return "the inclusion ratio of the trust at the time of any trust distribution to a non-skip person, as well as information regarding any trust modification or transaction with another trust that occurred during that year"; this information is described as providing information for a comprehensive statistical data base about trusts rather than for targeting trust audits, but the reporting could be very burdensome and, for many, quite ominous; applicable to taxable years ending after the date of enactment
- Not included: reducing the estate and gift tax exclusion amount prior to 2026 or including grantor trust assets in the grantor's gross estate under §2901

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

- Defined value formula clauses to determine the value of gifts or bequests that depend on some activity of the IRS would not be recognized, other than a formula clause defining a marital or exemption equivalent bequest at death based on the decedent's remaining transfer tax exclusion amount.
    - Reasons given for the proposal are (i) the clauses allow donors to escape gift taxes for undervaluing transfers, (ii) the clauses make gift tax return examinations and litigation cost-ineffective, (iii) transferred property must be reallocated among donees long after the gift, and (iv) the property rights of donees are determined in a tax valuation process in which they cannot participate.
    - The proposal literally says "the value of such gift or bequest will be deemed to be the value as reported on the corresponding gift or estate tax return"; wouldn't donors love having the reported value being automatically accepted as the final value? – that obviously is not intended but presumably the quantity of the transfer (number or percentage of shares or units) would be deemed to be the quantity estimated on the return.
    - Clauses with a formula based on an appraisal within a reasonably short period of time (as in *Nelson v. Commissioner*) would be recognized (even if the appraisal is "after the due date of the return").
    - This proposal also appears to target inter vivos or testamentary charitable lead annuity trusts (CLATs) that define the charitable annuity amount by a formula to reduce the remainder to zero or some specified value.
    - The proposal would be effective for transfers by gift or at death after 2023 (changed to 2024 in the FY25 Greenbook).
- "Simplify" the exclusion from gift tax for annual gifts; this proposal would limit the annual exclusion for many types of gifts to $50,000 per donor; this is similar to prior proposals from the Clinton and Obama Administrations as well as a proposal in section 10 of Senator Sanders' "For the 99.5 Percent Act"; the proposal would be effective for gifts after 2023 (changed to 2024 in the FY25 Greenbook).
- Several proposals impact GST tax issues:
    - A purchase of assets from a GST-tax-non-exempt trust or any other property subject to GST tax would be treated as an addition to trust principal requiring a redetermination of the purchasing trust's inclusion ratio (by adding the purchased assets to the denominator of the applicable fraction); the proposal would also apply to a decanting transaction (presumably from a non-exempt trust); effective for transactions occurring after the date of enactment;
    - Although under current law, charitable entities are treated as assigned to the transferor's generation under §2651(f)(3) and §501(c)(3,) charities would not be counted as having an interest in the trust for purposes of delaying a taxable termination (§2652(c)(1)(B)); the proposal would also to exclude §501(c)(4)s (and other designated exempt organizations) as having an interest in the trust for that purpose; and
    - Loans from a trust to a beneficiary would be treated as a distribution for GST tax purposes and a refund of GST tax paid as a result of such deemed distribution could be requested within one year after the loan is repaid in full; furthermore repayment of a loan to the grantor or deemed owner of a trust would be treated as a new contribution to the trust for GST tax purposes; the proposal would apply to loans made, renegotiated, or renewed by trusts after the year of enactment.
- As part of the loan proposal described immediately above, loans from a trust to a beneficiary would be treated as a distribution for purposes of carrying out DNI to the

borrowing beneficiary; the loan provision (including the GST tax provisions described above) apparently would apply to loans of property as well as cash loans because the proposal says the IRS may by regulations except certain loans such as short-term loans or the use of real or tangible property for a minimal number of days.

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

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

- Limit the use of donor advised funds (DAFs) to avoid the private foundation annual 5% payout requirement (i.e., distributions from a private foundation to a DAF would not be a qualifying distribution unless the DAF makes a qualifying distribution of those funds by the end of the following taxable year, and the FY24 Greenbook adds that a qualifying distribution under this exception does not include a distribution to another DAF); this is different from additional restrictions that would be imposed on DAFs and private foundations generally under the Accelerating Charitable Efforts (ACE) Act introduced in the House and Senate (H.R. 6595 and S. 1981) in 2021 and 2022.
- Private foundation payments to disqualified persons (other than a foundation manager who is not a family member of any substantial contributor) for compensation or expense reimbursement would not satisfy the annual 5% payout requirement for foundations, but they would still qualify for the exception from self-dealing if the payments are reasonable and necessary to carry out the foundation's exempt purposes (new in FY24 Greenbook).

(6) **Retirement Plan Issues.**

- Retirement accounts (including IRAs) owned by high-income taxpayers ($450,000 for married filing jointly, indexed) with an account balance exceeding $10 million on the last day of the preceding calendar year would be required to distribute at least 50% of the excess (with additional requirements for accounts exceeding $20 million), subject to the

25% penalty (10% if corrected within a specified period) for failing to take required minimum distributions (RMDs).

- High-income taxpayers ($450,000 for married filing jointly, indexed) could not roll over a retirement account that is not a Roth IRA or a Roth account to a Roth IRA.

b. **Additional IRS Funding from Inflation Reduction Act.** The Inflation Reduction Act of 2022 included $79.6 billion of additional long-term IRS funding available until September 30, 2031. Included amounts were $3.18 billion for taxpayer services, $45.64 billion for enforcement, $25.33 billion for operations support, $4.75 billion for business services modernization, and about $700,000 for various other purposes. In addition, another $15 million was included for a task force to design an efile tax return system that would not be run by the IRS.

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

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

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

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

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

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

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

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

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

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

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

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

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

personnel. Total enforcement staffing on September 3, 2023, was 13,498, and the goal is to increase staffing by a net of 5,462 personnel, or a 40.5% increase, by September 30, 2024.

The February 2024 Congressional Budget Office report mentioned above similarly observed that

> through 2023, the IRS hired fewer revenue agents (the enforcement staff who handle complex audits) than it had planned. That shortfall suggests that the IRS has encountered greater difficulty in hiring auditors than it anticipated. CBO expects that the IRS will be able to use all the mandatory funding that it designated for hiring in later years, but because of the delays in hiring and training new auditors, revenue collections from enforcement activities are smaller in CBO's February 2024 projections than they were in its previous projections.

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

c. **Likelihood of Tax Legislation; What Will Happen to the Estate and Gift Tax Basic Exclusion Amount?** The 2022 midterm election suggests that the country is very evenly divided politically, with Democrats in control of the Senate and Republicans in control of the House. The split Congress means that a major tax legislative package is very unlikely and the likelihood of any significant transfer tax legislation (or legislative changes regarding grantor trusts) is also very unlikely for at least the rest of 2024.

The bipartisan $78 billion Tax Relief for American Families and Workers Act of 2024 (H.R. 7024) was approved by the House Ways and Means Committee by a significant bipartisan vote of 40-3 and was approved by the House on January 31, 2024, by a vote of 357-70. It includes various business tax breaks, including several Tax Cuts and Jobs Act extenders of business tax matters (perhaps most notably, retroactive rollbacks of the tightening under the Tax Cuts and Jobs Act of research and developments expensing, bonus deprecation, and net interest expensing through 2025) as well as expansion of the child tax credit. Extension of the individual income tax provisions in the Tax Cuts and Jobs Act are not included. Even this limited tax bill faces difficulty in the Senate and is not necessarily a priority for near-term passage. *See* Samantha Handler, *What's Next for the Tax Bill? Three Questions After Panel Markup*, BLOOMBERG DAILY TAX REPORT (Jan. 22, 2024).

The likelihood of the $10 million (indexed) estate and gift basic exclusion amount being reduced before it is scheduled to be reduced to $5 million (indexed) in 2026 is very small. Even if one party wins control of the Administration and Congress in 2024 elections, the new Congress would not be seated until 2025, so a change in the exclusion amount before 2026 would occur mid-year in 2025 (or perhaps retroactive to January 1, 2025), both of which are extremely unlikely. Whether the $10 million (indexed) exclusion amount is extended beyond 2025 will depend in part on whether compromises can be reached to achieve some tax legislative changes in the 2023-2024 Congress (which is unlikely, as discussed above). If not, the 2024 elections could have some impact on that issue. However, even if the Democrats should win control of the Administration, Senate and House for 2025, do not assume the exclusion amount will necessarily be allowed to revert back to $5 million (indexed) (likely something in excess of $7 million in 2025). Remember that late in the second year of the Obama Administration, when Democrats controlled the Administration, Senate and House, legislation was passed that increased the gift exclusion amount from $1 million to $5 million (effective 1-1-11), increased the estate exclusion amount and GST exemption from $3.5 million to $5.0 million (effective 1-1-10), decreased the transfer tax top rate from 40% to 35% (effective 1-1-10 for estate tax and 1-1-11 for gift and GST tax), began indexing the exemption in 2012, and added portability of the unified credit. Who would have thought the Democratic controlled Congress and Presidency would have agreed to such massively advantageous transfer tax changes? They did – as a result of ***negotiation***, and it could happen again.

A common misbelief is that the exemption amount has never gone down, so we could anticipate that it will not go down in 2026. That is not exactly true. While the estate tax exemption amount has rarely decreased from 1916 when the estate tax was enacted, it did go down from $100,000 to

$50,000 in 1932-1933, and decreased again from $50,000 to $40,000 in 1935-1941. But after increasing to $60,000 in 1942, the estate tax exemption amount has never decreased.

At this point, the "bottom line" for planners is that at least a significant possibility exists that the exemption amount will decrease in 2026 (from about $14 million to about $7 million), and planners should advise their clients of that possibility so that clients can make an informed decision as to whether to make use of the large $10 million (indexed) exclusion amount while it exists.

Looking forward, planners can anticipate that the decision about whether the exclusion amount (and many other tax cuts under the 2017 Tax Cuts and Jobs Act) will expire at the end of 2025 will not be resolved until December 2025 (or even later). Planners will be very busy in the fall of 2025 advising clients about possible alternatives for making use of the large exclusion amount while it exists, in case it should be decreased in 2026. For example, transfers to QTIP trusts could leave open the option of whether the transfer will be a taxable transfer making use of the exemption amount, based on whether the QTIP election is made on the gift tax return that would not be due until October 2026, if the gift tax return due date is extended. And clients who make large gifts in 2025, only to find out that Congress later keeps the exclusion from going down, may be upset with having made the large gifts and look for ways to "undo" the gifts.

In any event, we've been there before, and the fall of 2025 could be a very busy season for planners.

d. **Accelerating Charitable Efforts (ACE) Act Proposal.** Sen. Angus King (I-ME) and Sen. Chuck Grassley (R-IA) on June 9, 2021, introduced bipartisan legislation, the Accelerating Charitable Efforts (ACE) Act, tightening restrictions on donor advised funds (DAFs) and private foundations. An essentially identical proposal, H.R. 6595, was introduced in the House on February 3, 2022, by Representative Chellie Pingree (D-ME). A similar proposal was not introduced in 2023.

This proposal includes –

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

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

e. **Extending (or Making Permanent) the TCJA 2017 Tax Cuts.** The "TCJA Permanency Act," H.R. 976 (Feb. 10, 2023), introduced by Representative Vern Buchanan (R-FL) would make permanent certain provisions of the Tax Cuts and Jobs Acts affecting individuals and small businesses, including making permanent the increase in the estate and gift tax basic exclusion amount. S. 1226 (April 20, 3032, introduced by Senator Ted Cruz (R-TX) is the slightly shorter Senate companion, also making permanent the estate and gift tax exclusion amount.

The Committee for a Responsible Federal Budget, based on projections from the Congressional Budget Office and Joint Committee on Taxation, estimates that extending the Tax Cuts and Jobs Act in full would cost over $3.3 trillion through 2033, or $3.8 trillion with interest. Extending individual provisions that expire at the end of 2025 would cost $3.4 trillion through 2035. Tax Cut Extension Cost Over $3.3 Trillion, Committee for a Responsible Federal Budget (August 14, 2023) available at **https://www.crfb.org/blogs/tax-cut-extensions-cost-over-33-trillion**.

f. **"For the 99.5 Percent Act."** On April 18, 2023, Senator Bernie Sanders (I-VT) introduced S. 1178 titled "For the 99.5 Percent Act," similar to bills Senator Sanders has introduced in every Congress since 2010 making far-reaching changes to estate, gift and generation-skipping transfer tax

provisions. For a brief overview of the version introduced in 2021, see Item 2.n of Estate Planning Current Developments (December 2021) found **here**, and for a much more detailed summary of the bill introduced in 2023 (and his prior similar bills), see Item 1.b of Aucutt, Washington Update: Pending and Potential Administrative and Legislative Changes (February 2024) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

a. **2023-2024, 2022-2023 and 2021-2022 Treasury-IRS Priority Guidance Plans.** The 2023-2024 Treasury-IRS Priority Guidance Plan (released September 29, 2023) adds two new projects in the "Gifts and Estates and Trusts" section.

(1) Regulations under §645 pertaining to the duration of an election to treat certain revocable trusts as part of an estate (Number 1). Under Reg. §1.645-1(f)(2)(ii)(A), one of the measurements of the termination of an election under section 645 is the day before the date that is 12 months after the IRS issues an estate tax closing letter (unless a claim for refund has been filed within that 12 months). Because the IRS no longer routinely issues estate tax closing letters, this measurement may no longer be appropriate, and removing or replacing it may be one of the objectives of this regulation project.

(2) Regulations under §6011 identifying a transaction involving certain uses of charitable remainder annuity trusts as a listed transaction (Number 10). (These regulations were released March 22, 2024 (see Item 4.m below).

A new item in the "Exempt Organizations" section is guidance addressing the SECURE 2.0 Act changes relating to §529 (Number 4). SECURE 2.0 permits a beneficiary of 529 accounts to roll over up to $35,000 over her lifetime from any 529 account into her Roth IRA if the 529 account has been open more than 15 years; presumably the guidance is about that provision.

The 2023-2024 Plan deletes several projects in the "Gifts and Estates and Trusts" section that were finalized in the last Plan year: (1) basis adjustment under §1014 for grantor trusts not included in the grantor's gross estate (Rev. Rul. 2023-2 was published, discussed in Item 4.c below); (2) guidance on portability regulatory elections (addressed in Rev. Proc. 2022-32, discussed in Item 4.e below); and (3) regulations under §7520 regarding actuarial tables (the final regulation was released June 1, 2023, discussed in Item 4.k below).

The 2022-2023 Treasury-IRS Priority Guidance Plan (released November 4, 2022) added three new projects in the "Gifts and Estates and Trusts" section:

(1) Guidance regarding availability of §1014 basis adjustment at the death of the owner of a grantor trust described in §671 when the trust assets are not included in the owner's gross estate for estate tax purposes (Number 2) (this project was completed with the issuance of Rev. Rul. 2023-2, discussed in Item 4.c below);

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

(3) Guidance on portability regulatory elections under §2010(c)(5)(A) (Number 4) [already published as Rev. Proc. 2022-32 when the 2022-2023 Plan was released] (discussed in 4.e below).

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

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

The following are items regarding gifts and estates and trusts in the 2023-2024 Plan.

GIFTS AND ESTATES AND TRUSTS

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

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

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

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

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

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

7. Regulations under §2632 providing guidance governing the allocation of generation-skipping transfer (GST) exemption in the event the IRS grants relief under §2642(g), as well as addressing the definition of a GST trust under §2632(c), and providing ordering rules when GST exemption is allocated in excess of the transferor's remaining exemption.

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

9. Final regulations under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates. Proposed regulations were published on September 10, 2015.

10. Regulations under §6011 identifying a transaction involving certain uses of charitable remainder annuity trusts as a listed transaction.

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

The 2023-2024 Plan sets the priority for guidance projects during the Plan year (from July 1, 2023, to June 30, 2024), but no deadline is provided for completing the projects.

Proposed regulations were issued in 2022 with respect to two of the items on the Plan (Numbers 3 [abuse exception to the anti-clawback regulation], and 5 [§2053]) and final regulations were issued for the actuarial tables project (Number 11 on the 2022-2023 Plan).

Item 9, completion of final regulations on the taxation of gifts or bequests from certain expatriates, has been in process for a number of years. Tabetha Peavey of the Treasury Office of Tax Legislative Counsel reported at the ABA Section of Taxation January 2024, meeting that Treasury is "nearing completion" of these regulations. *See* Jonathan Curry, *ABA Section of Taxation Meeting: Guidance Banning 'Hoffman' CRATs is Imminent*, 182 TAX NOTES FEDERAL 948 (Jan. 29, 2024).

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

These regulations are reportedly a high priority with the IRS and Treasury. Informal comments since May 2022 indicate that the basis consistency final regulations "may be coming soon." "We haven't forgotten about…I'm hoping that we'll be able to get those out soon." *See* Jonathan Curry, *Treasury and IRS Teeing Up Proposed Regs on Personal Guarantees*, 175 TAX NOTES FEDERAL 1286 (May 16, 2022) (Comment by Cathy Hughes, Treasury Department Office of Tax Policy, at ABA Tax Section meeting in May 2022).

For a detailed discussion of this project, see Item 5.b of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (February 2024) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

This much narrower topic, about grantor trusts for which the assets are not included in the grantor's gross estate, was included for the first time as Number 2 of the Gifts and Estates and Trusts issues on the 2022-2023 Plan. It apparently is the IRS's response to political pressure (see Item 4.c(3) below).

Beginning in 2015, the IRS no-ruling list has included whether "the assets in a grantor trust receive a Section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner …" *E.g.*, Rev. Proc. 2024-3, 5.01(10).

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

(2) **Arguments.** Some planners maintain that assets in a grantor trust should receive a basis step-up at the grantor's death because until that time the assets were deemed owned by the grantor for income tax purposes (*see* Rev. Rul. 85-13, 1985-1 C.B. 184), and after the grantor's death they are "acquired from a decedent" by someone else. *See*, *e.g.*, Mitchell Gans & Jonathan Blattmachr, *Grantor Trust Assets and Section 1014: New Ruling Doesn't Solve the Problem*, 139 J. TAX'N 16 (Sept. 2023); Jonathan Blattmachr, Mitchell Gans & Hugh Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (Sept. 2002); Treas. Reg. §1.1001-2(c)Ex. 5 (grantor of grantor trust was considered the owner of all trust property in a grantor trust and when grantor renounced powers that caused trust to be a grantor trust, partnership interest owned by the trust was considered to have been transferred from grantor to trust for federal income tax purposes). Many other planners are uncomfortable with that position. *See* Austin Bramwell & Stephanie Vera, *Basis of Grantor Trust Assets at Death: What Treasury Should Do,* 160 TAX NOTES FEDERAL 793 (Aug. 6, 2018) (suggesting that §1015(b) could provide a rationale for not adjusting basis of grantor trust assets at the grantor's death).

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

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

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

Secretary Yellen: "Very soon. Very soon."

Rep. Pascrell: "Thank you."

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

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

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

The complete holding of the Ruling is:

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

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

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

(6) **Treatment of §1014(b) Categories as Exclusive Ways to be "Acquired From" or "Passed From" the Decedent.** Rev. Rul. 2023-2 says the **only way** an asset can be "acquired from a decedent" for purposes of getting a basis adjustment under §1014(a) is to be in one of the categories listed in §1014(b), and it reasoned that none of the sub-sections in §1014(b) applies.

From the Ruling: "For property to be acquired or passed from a decedent for purposes of § 1014(a), it **must** fall within one of the seven types of property listed in § 1014(b)." (emphasis added). The ruling does not cite any authority for the proposition that the seven types of situations listed in §1014(b) are the only ways property can be acquired from a decedent for purposes of §1014(a).

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

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

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

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

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

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

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

(9) **Penalties.** If a taxpayer wants to take the position that the IRS's position in Rev. Rul. 2023-2 is wrong, the recipient of the grantor trust asset might want to report capital gain upon the sale of the asset as if no basis adjustment applied, and then claim a refund, taking the position that a

basis adjustment did apply at the death of the grantor of the grantor trust. That approach would avoid underpayment penalties if the taxpayer's position were not upheld.

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

(10) **Background Information.** For a more detailed discussion of this issue, see Item 6.c of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and Item 5.i of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (February 2024) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

d. **Anti-Abuse Exceptions to Anti-Clawback (Number 3).** Number 3 addresses the anti-abuse exception to the clawback regulation. The IRS released proposed regulations on April 26, 2022, discussed in Item 5 below.

e. **Portability Regulatory Election Extensions Increased from Two to Five Years, Rev. Proc. 2022-32 (Number 4 of 2022-2023 Priority Guidance Plan).** In a project that was added as Number 4 of the 2022-2023 Priority Guidance Plan, the IRS announced in Rev. Proc. 2022-32 that it is extending from two to five years from the decedent's date of death the period for obtaining an extension to file a late estate tax return to make the portability election without going through the expensive and time-consuming process of requesting a private letter ruling (which also avoids the necessity of paying a hefty user fee for a ruling under §301.9100-3 to obtain an extension). For a discussion of Rev. Proc. 2022-32 and the various regulatory extensions that have been granted, see Item 5.c of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found **here** and Item 29.d of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (September 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

f. **Alternate Valuation Period (Number 4).** This project has been on the Plan for a number of years. For further discussion of this project see Item 6.d of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

g. **Section 2053 Proposed Regulations (Number 5).** Proposed regulations were released on June 24, 2022, and published in the Federal Register on June 28, 2022. These regulations eventually could have a profound impact on planning and the deductibility of certain administrative expenses for estate tax purposes. The proposed regulations and planning implications are discussed in Item 6 below.

h. **Qualified Domestic Trust Elections (Number 6).** The QDOT project apparently is merely "updating obsolete references."

i. **GST Exemption Allocation (Numbers 7-8).** Number 7 first appeared in the 2021-2022 Plan, but it is related to Number 8, which has been in Plans for a number of years, first appearing in the 2007-2008 Plan. For a discussion of these projects, see Item 5.h of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (February 2024) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

j. **Tax Under §2801 on Gifts from Expatriates (Number 10).** This item first appeared in the 2008-2009 Plan, and proposed regulations were issued in 2015. The item was dropped from the 2017-2018 Plan and has not been in the Plan since then. Informal statements from Treasury officials indicate this project may be "nearing completion." See Item 3.a above. For a discussion of this issue, see Item 29.i of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (September 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

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

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

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

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

In what perhaps is the most controversial provision, the IRS proposes that compensation from a DAF to an investment advisor who advises the donor regarding the DAF and also provides investment advice to the donor on personal investments would be an "excess benefit" subject to a 25% excise tax under §4958 unless the advisor provides investment advice to the supporting organization of the DAF as a whole. *See* Jonathan Curry, *Estate Planner Takes Issue With 'Surprising' Proposed DAF Regs*, 182 TAX NOTES Federal 554 (Jan. 15, 2024) (summarizing comments of Carlyn McCaffrey at the 2024 Heckerling Institute).

The effective date provision raises concerns; the effective date is the tax year in which the regulations become final. This means the regulations will apply retroactively to transactions that occur during the taxable year the final regulations are issued including before the issuance date. (For example, investment management fees paid to "donor advisors" during that taxable year before the

issuance date would be subject to the 25% excise tax, and the compensation would have to be returned to the sponsoring organization.)

m. **Proposed Regulation Treating The Use of Certain Abusive Charitable Remainder Annuity Trusts as a Listed Transaction.** This is part of the project of issuing proposed regulations regarding various "listed transactions" in light of the Tax Court's holding in *Green Valley Investors, LLC v. Commissioner*, 159 T.C. 80 (2022) (Reviewed by the Court) that prior Notices describing listed transactions did not comply with the Administrative Procedure Act. See Item 21.c of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

Proposed regulations were released March 22, 2024 (scheduled to be published in the Federal Register on March 25, 2024), identifying as a listed transaction the use of abusive charitable remainder annuity trusts that purchase a single premium immediate annuity (SPIA) to permanently avoid recognition of ordinary income and/or capital gain. Prop. Reg. §1.6011-15. The beneficiary would treat "the annuity amount payable from the trust as if it were, in whole or in part, an annuity subject to section 72, instead of carrying out to the beneficiary amounts in the ordinary income and capital gain tiers of the trust in accordance with section 664(b)." REG-108761-22, preamble at 13-14.

n. **Letter to Treasury from Senators Asking for Regulatory Crackdown on GRATs and Grantor Trusts.** A letter dated March 20, 2023, from four prominent Senators (two members of the Senate Finance Committee (Elizabeth Warren, D-MA, and Sheldon Whitehouse, D-RI) and Senators Chris Van Hollen, D-MD, and Bernard Sanders, I-VT) details what they view as a "blatant abuse of our tax system," and requests Treasury to take *regulatory* steps to remove many of the transfer planning advantages of GRATs and grantor trusts. *See* Alan Gassman, *Bernie Sanders and Elizabeth Warren Win a Battle in the War on the Taxation of Grantor Trusts*, FORBES (April 5, 2023). This request for current *regulatory* action is in the face of unsuccessful legislative attempts over multiple years to address some of the advantages of GRATs and grantor trusts. Indeed, the 2023 and 2024 FY Greenbooks again make various legislative proposals to take away some of the transfer planning opportunities of GRATs and grantor trusts, as discussed in Item 3.a(3) above and Item 3.a(4) above. With the Republicans having majority control of the House of Representatives, the only way some of the trust-limiting measures can proceed currently may be through administrative action.

The letter urges that Treasury has the authority and should take various steps administratively to cut back on what it views as abusive wealth shifting opportunities: (1) revoke Rev. Rul. 85-13; (2) revoke Rev. Rul. 2004-64; (3) require GRATs to have a minimum remainder value (for example, 25% of contributed assets); (4) reissue the §2704(b) proposed regulations; (5) confirm Chief Counsel Advice 200937028 (the IRS did this by issuing Rev. Rul. 2023-2 regarding the basis of assets in a grantor trust if the trust is not included in the grantor's gross estate); and (6) adopt more restrictions for GRATs (minimum and maximum permitted terms, treat swaps as prohibited additional contributions, and limitations on valuation of transferred remainder interests). For a more detailed discussion of the recommendations in that letter, see Item 5.m of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

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

- Basic exclusion amount and GST exemption – $13,610,000 in 2024, $12,920,000 in 2023, $12,060,000 in 2022, $11,700,000 in 2021 (observe, the $860,000 and $690,000 increases

for 2023 and 2024 are much larger than prior year inflation adjustment increases and leave substantial additional gift exclusion for additional gifts by those donors who have previously utilized all of their gift exclusion);

- Gift tax annual exclusion – $18,000 in 2024, $17,000 in 2023, $16,000 in 2022, $15,000 in 2018-2021 (observe that the annual exclusion was $15,000 for four years [2018-2021], but it has increased by $1,000 in each of 2022-2024, and likely will increase by another $1,000 in 2025);
- Estates and trusts taxable income for top (37%) income tax bracket – $15,200 in 2024, $14,450 in 2023, $13,450 in 2022, $13,050 in 2021;
- Top income tax bracket for individuals – $731,200/$609,350 (married filing jointly/single) in 2024, $693,750/$578,125 in 2023, $647,850/$539,900 in 2022, $628,300/$523,600 in 2021;
- Taxable income threshold for §199A qualified business income – $383,900/$191,950 (married filing jointly/single) in 2024, $364,200/$182,100 in 2023, $340,100/$170,050 in 2022, $329,800/$164,900 in 2021;
- Standard deduction – $29,200/$14,600 (married filing jointly/single) in 2024, $27,700/$13,850 in 2023, $25,900/$12,950 in 2022, $25,100/$12,550 in 2021;
- Non-citizen spouse annual gift tax exclusion – $185,000 in 2024, $175,000 in 2023, $164,000 in 2022, $159,000 in 2021;
- Section 6166 "two percent amount" – $1,850,000 in 2024, $1,750,000 in 2023, $1,640,000 in 2022, $1,590,000 in 2021; and
- Special use valuation reduction limitation – $1,390,000 in 2024, $1,310,000 in 2023, $1,230,000 in 2022, $1,190,000 in 2021.

The estate and gift exclusion amount is estimated to increase about another $500,000 in 2025 to $14,110,000. This suggests that if the estate and gift exclusion amount decreases from $10 million (indexed) to $5 million (indexed) in 2026, it would be some amount over $7 million in 2026.

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

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

r. **IRS Tweaking Estate and Gift Tax Returns for e-Filing.** The IRS will be making some changes to estate and gift tax returns in the next year or two as it plans for allowing e-filing of estate and gift tax returns. This is part of IRS's goal to go paperless by 2025. Some estate tax returns span thousands of pages and are shipped in boxes to the IRS. "The bevy of exhibits and attachments that often accompanies estate and gift tax returns makes the transition from paper to electronic filing of those returns a challenge." Attachments often have "unstructured data" that is not easily converted to a

digital format. *See* Jonathan Curry, *ABA Section of Taxation Meeting: E-Filing Could Prompt Tweaks to Estate and Gift Tax Returns*, 182 TAX NOTES FEDERAL 961 (Jan. 29, 2024).

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

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

Id. at n.15.

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

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

b. **General Anti-Clawback Rule.** If a client made a $12 million gift in 2022 (when the gift exclusion amount was $12.06 million) but dies in 2026 after the basic exclusion amount has sunsetted to $5 million indexed (say $7 million), the $12 million is added into the estate tax calculation as an adjusted table gift, but the estate exclusion amount is only $7 million. So, will estate tax be owed on the difference? The special anti-clawback rule in Reg. §20.2010-1(c)(1) allows the estate to compute its estate tax credit using the higher of the BEA applied to gifts made during life or the BEA applicable on the date of death. Therefore, in the example above, if the donor dies when the BEA is $7 million, the $12 million gift would be included in the estate tax calculation as an adjusted taxable gift, but the available exclusion amount would be the larger of the $7 million BEA at the date of death or the $12 million of BEA applied to gifts made during life, or $12 million. For a detailed discussion of the estate tax calculation process and the operation of the anti-clawback special rule, see Item 4 of Estate Planning Current Developments and Hot Topics (December 2019) found **here**, and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

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

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

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

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

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

6. Section 2053 Proposed Regulations

Proposed regulations were released on June 24, 2022, and published in the Federal Register on June 28, 2022 (REG-130975-08), addressing Number 5 on the list of estate related projects on the 2021-2022 Priority Guidance Plan and Number 6 on the 2022-2023 Plan mentioned in Item 4.a above.

a. **Overview of Topics Addressed.** The proposed regulations address four general topics about deductions for claims and administration expenses under §2053: (1) applying present value concepts, (2) deductibility of interest, (3) deductibility of amounts paid under a decedent's personal guarantee, and (4) curing technical problems of references in existing regulations to a "qualified appraisal" for valuing claims by instead describing requirements for a "written appraisal document." The first two are briefly summarized below. For a more detailed discussion of those two and for a summary of the last two, see Item 7 of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

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

typical for taxable estates (the ones for which the administration expense is important), especially taxable estates that undergo an estate tax examination.

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

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

(2) **Interest on Loan Obligations of the Estate.** A considerable number of cases have addressed the deductibility of interest under §2053 on funds borrowed to pay estate taxes. For descriptions of many of these cases, see section VII.D of Akers, Modern Estate *Administration—New (As Well as Old) Issues Arising After Death,* 58TH ANNUAL HECKERLING INST. ON EST. PL. (2024) (available from author). The Preamble observes that this issue "has been litigated often, with varying results" and that the proposed regulation will "provide guidance."

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

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

(2) executor enters the loan arrangement,

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

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

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

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

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

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

(9) lender is not a substantial beneficiary,

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

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

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

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

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

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

(4) the only practical alternatives to the loan are the sale of assets at significantly below-market prices, the forced liquidation of an entity that conducts an active trade or business, or "some similarly financially undesirable course of action";

(5) the estate does not have liquidity to pay estate liabilities, the estate does not have control of an entity with liquid assets to satisfy estate liabilities, the estate has no power to compel an entity to sell liquid assets and make distributions, and the estate will have sufficient cash flow to make the loan payments [an example of these factors is *Estate of Black v. Commissioner*, 133 T.C. 340 (2009) (an FLP in which the estate owned a substantial interest sold assets for $98 million and made a $71 million loan to the estate; court reasoned in part that the estate had no way to repay the loan other than actually receiving a distribution from or having its partnership interest redeemed by the partnership); on the other hand, various cases (all cited below) have refused to second guess the business judgment of the executor about retaining an appropriate level of liquid assets, *Estate of Murphy, Jr. v. U.S.*, *McKee v. Commissioner*, *Estate of Thompson v. Commissioner*, *Estate of Duncan v. Commissioner*, *Estate of Sturgis v. Commissioner*];

(6) the estate's illiquidity does not occur as a result of a "testamentary estate plan to create illiquidity" or action or inaction by the executor when a reasonable alternative could have avoided or mitigated the illiquidity;

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

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

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

The illiquidity factor has been addressed in several of the cases regarding the deductibility of interest on a loan obtained to pay estate taxes. For example, in *Estate of Murphy, Jr. v. U.S.*, 104 AFTR 2d 2009-7703 (W.D. Ark. 2009), the estate borrowed $11,040,000 from an FLP on a 9-year *Graegin* note (i.e., which had a fixed term and interest rate and which prohibited prepayment). The estate also borrowed an additional $41.8 million from a prior trust on a "regular" note (i.e., that had a floating interest rate and that permitted prepayment). The court refused to deny the deduction because an FLP did not sell assets and make a large distribution to the estate, reasoning that "[i]f the executor acted in the best interest of the estate, the courts will not

second guess the executor's business judgment." (Citing *McKee v. Commissioner*, 72 T.C.M. 324, 333 (1996).)

The net effect is that "*Graegin* loans" (see *Estate of Graegin* v. Commissioner, T.C. Memo, 1988-477) will be significantly restricted under the proposed regulations. Even if a deduction is allowed for post-death interest accruing on the loan, the deduction for interest paid after three years following date of death (which may be all of the interest) will be discounted as discussed above. Proposed Reg. §20.2053-1(d)(6). Furthermore, an interest deduction may be denied totally for some loans after applying the 11 factors listed in the proposed regulations. **Those factors generally reflect issues that have been addressed in various cases involving loans obtained to pay estate taxes, but some cases have not been as restrictive as is suggested by the listed factors.** For example, one of the negative factors derived from the proposed regulations is that the lender is a beneficiary or entity in which the beneficiary has control, but various cases have permitted a deduction for interest paid to a beneficiary or family entity.

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

d. **ACTEC Comments.** ACTEC filed comments with the IRS on September 22, 2022. The comments address (i) the illiquidity and "beneficiary as lender" issues as factors about whether interest is deductible, (ii) the penalties of perjury requirement for appraisals of claims, and (iii) the impact of receiving full consideration for personal guarantees. The ACTEC comments are available at **https://www.actec.org/legislative-comments/actec-submits-comments-regarding-proposed-regulations-under-code-section-2053/**.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In certain situations (for example, with very large trusts), the likelihood that a trustee would make reimbursement payments or that making reimbursement payments to the grantor would reduce the amount of any discretionary distributions to any current beneficiaries may be infinitesimally small. Theoretically, gifts might be made by remote descendants who would eventually receive the trust assets outright at the trust termination (which could be hundreds of years in the future), but how can unborn persons make gifts (even if some attorney representing the unborn descendants consents to the modification)? At what point would any such theoretical gift, by reason of consenting to the modification, be incomplete? *See generally* Diana Zeydel, *When Is a Gift to a Trust Complete: Did CCA 201208026 Get It Right?,* 117 J. TAX'N 3 (September 2012); Diana Zeydel, *Developing Law on Changing Irrevocable Trusts: Staying Out of the Danger Zone*, 47 REAL PROP. TR. & EST. L.J. 1 (Spring 2012) (discussing tax effects of trust modification, rescission, reformation, or decanting transactions).

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

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

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

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

f. **Application to Decanting Transactions.** Decanting transactions are probably much more common than trust modification transactions. Will beneficiaries in all decanting transactions have to be concerned about gift implications? Under some state laws, beneficiaries' consent may be required, but under many state laws beneficiary consent is not required, though a beneficiary could sue the trustee for breach of trust regarding the changes made in any particular decanting transaction. The

CCA explicitly stated that "[t]he result would be the same if the modification was pursuant to a state statute that provides beneficiaries with a right to notice and a right to object to the modification and a beneficiary fails to exercise their right to object."

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

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

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

j. **Trend to Increased Focus on Gifts Effects of Modifications or "Failure to Object" Transactions?** CCA 202352018 has caused consternation among many planners who wonder if it hints at a new focus by the IRS on "failure to object" or consent transactions. *See* Paul Hood & Ed Morrow, *CCA 202352018: The Trustee's Discretionary Power to Reimburse a Settlor/Grantor for the Income Tax Paid on the Trust's Income*, Leimberg Estate Planning Newsletter #3098 (Feb. 5, 2024) ("While such valuation difficulties don't prevent the existence of a gift, we strongly suspect that both the valuation difficulty and the likely very small taxable gift that might result will effectively preclude the IRS from employing its limited resources in cases like these to the most low-hanging fruit. We submit that the IRS may be using this occasion to rethink other more substantial trust modifications that might more clearly involve a true transfer of wealth.")

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

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

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

k. **Remember What a CCA Is.** A Chief Counsel Advice is not a published ruling by the IRS or even an informal statement of the IRS's position about an issue generally. A Chief Counsel Advice typically

arises in a specific examination that may be headed to litigation. It may be requested by the examiner for direction regarding positions to take in that specific examination, but more important, to encourage a settlement by the taxpayer, who would know that his or her position is rejected by the national office of the IRS Chief Counsel.

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

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

8. Corporate Transparency Act Overview

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

The CTA requires that certain entities must disclose to the Financial Crimes Enforcement Network ("FinCEN") identifying information about individual owners and those who control the entity ("Beneficial Owners") and "Applicants" applying to form an entity. A national registry of entities and their applicants and owners will be created. FinCEN estimates that 32,556,929 entities will submit reports in 2024, and in subsequent years it estimates that about five million reports will be filed each year.

Final regulations regarding beneficial ownership, reporting requirements, and exemptions from reporting were released on September 29, 2022, with an effective date of January 1, 2024. Following is a brief overview of highlights of the beneficial ownership reporting requirements. For a more detailed summary of the reporting requirements under the CTA see Item 3 of Estate Planning Current Developments and Hot Topics 2022 (December 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** A 50-page guide from FinCEN, titled "Small Entity Compliance Guide" (Version 1.1, dated December 2023), is available from the FinCEN webpage, **https://www.fincen.gov/news/news-releases/fincen-issues-compliance-guide-help-small-businesses-report-beneficial-ownership**. A 33-page Beneficial Ownership Information Reporting Frequently Asked Questions document, updated December 12, 2023, is available on the FinCEN website at **https://fincen.gov/boi/beneficial-ownership-information-frequently-asked-questions**.

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

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

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

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

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

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

(6) **Reporting Companies.** "Reporting Companies" that must report are corporations, LLCs, and other "similar entities" that are created by filing a document with a secretary of state or similar office or foreign entities registered to do business in the U.S. At this point, private trusts are not included among the entities that must report, and charitable organizations, including private foundations, are specifically exempt from the reporting requirements. Various highly regulated companies, such as banks and investment companies under the Investment Company Act of 1940 are also exempt. In all, 23 exceptions exist, one of which is for companies that employ more than 20 people, have gross receipts exceeding $5 million from domestic sources, and have a physical operating presence in the U.S. (The entity must have filed a federal income tax return for the previous year demonstrating $5 million in gross receipts or sales. Thus, the large company exempt category will not be available in the first year of the company's existence because it will not have filed a return in the prior year.) **Most of the corporations, limited partnerships, and LLCs that estate planning professionals create for their clients will NOT be exempt**.

(7) **Beneficial Owners, Particular Issues for Trusts.** A "Beneficial Owner" (who must be reported) is any individual who directly or indirectly (i) exercises substantial control over a Reporting Company or (ii) owns or controls at least 25% of the Reporting Company. Each entity must have at least one Beneficial Owner. An individual "exercises substantial control" if the individual has (i) a senior officer position, (ii) appointment/removal powers over any senior officers, (iii) direction or substantial influence over important matters, or (iv) any other form of substantial control.

If a trust exercises substantial control or owns at least 25% of the Reporting Company, the regulations generally treat as Beneficial Owners (i) a trustee "or other individual (if any) with the authority to dispose of trust assets," (ii) a trust beneficiary who "is the sole permissible recipient of income and principal from the trust" or who can demand distribution of or withdraw substantially all of the trust assets (observe, this would include spouse-beneficiaries of QTIP trusts), and (iii) the trust grantor or settlor who has the right to revoke the trust or otherwise withdraw all of its assets. 31 C.F.R. §1010.380(d))(2)(ii)(C).

The provisions in the regulations regarding trusts leave uncertainty about who might be included as having "authority to dispose of trust assets." Would that include –

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

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

The final regulation changed this language (in §1010.380(d)(2)(ii)) to refer to individuals directly or indirectly owning or controlling an ownership interest of a reporting company "through any

contract, arrangement, understanding, relationship, or otherwise, including" the same listed items. Does the elimination of "but not limited to" suggest that the listed items are the exclusive list of ways persons connected with a trust can be a Beneficial Owner? The regulations do not say the list is an exclusive list. Indeed, the preamble to the final regulations indicates that "those are specific examples of the more general principle" that "trust arrangements can vary significantly in form, so the examples in the final rule do not address all applications of the general principle." A footnote in the preamble observed that commenters had asked if trust protectors and advisors were included and asked how the regulation applied if "decisions concerning distributions were made by a committee."

The regulations do not address how this applies to corporate trustees; the CTA generally requires reporting about **individuals**, so will individuals who are primarily responsible for decisions on behalf of the corporate trustee for the trust have to be identified? The ACTEC Comments noted this uncertainty:

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

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

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

(9) **Beneficial Ownership Information Reports.** "Beneficial Ownership Information Reports" (sometimes referred to as "BOI Reports") must be filed by Reporting Companies. The Reporting Company must identify itself (full legal name, any trade name or doing business as name, current address, state of formation, and IRS taxpayer identification number) and report four pieces of information about beneficial owners (and, for companies created after January 1, 2024, about applicants who created the entity): (1) name, (2) birthdate, (3) address, and (4) a unique identifying number from an acceptable identification document (passport, state identification document, or driver's license), the name of the issuing jurisdiction, and an image of the document. If an individual provides the four pieces of information to FinCEN directly, the individual may obtain a "FinCEN Identifier," which can then be provided to FinCEN in a Beneficial Information Report in lieu of the required information about the individual. (Attorneys who form a substantial number of reporting entities may wish to obtain a FinCEN Identifier.)

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

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

(10) **Reporting Due Dates; Extension of Due Dates.** Reports will be required within 30 days after the company is created, but companies created before January 1, 2024, have one year to file the report – by January 1, 2025. Updated and corrected reports to report any change to information

previously reported concerning a Reporting Company or its beneficial owners must be filed within 30 days of when the change occurred. A corrected report must also be filed to report any inaccuracies in a report within 30 days of becoming aware of the inaccuracy.

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

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

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

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

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

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

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

https://fincen.gov/news/news-releases/fact-sheet-beneficial-ownership-information-access-and-safeguards-final-rule.

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

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

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

The government filed a notice of appeal with the Eleventh Circuit on March 11, 2024.

At least two other cases have been filed in federal courts challenging the constitutionality of the CTA. *Boyle v. Yellen*, No.24-00081 (D. Maine) (business owner seeking injunctive relief from CTA for himself); *Gargasz v. Yellen*, No. 23-cv-02468 (N.D. Ohio) (arguing invalidity of CTA and its regulations under the Constitution, the Paperwork Reduction Act, and the Administrative Procedure Act and seeking nationwide injunction).

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

d. **More to Come? Residential Real Estate Non-Financed Transfers, ENABLERS Act.**

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

FinCEN on February 7, 2024, filed Notice of Proposed Rulemaking (RIN 1506-AB54) that would impose requirements on "Reporting Persons" (professionals involved in closing residential real estate transfers, including settlement agents, title insurance agents, escrow agents, and attorneys) to report certain information about "beneficial owners" (similar to the description of beneficial owners under the CTA) for non-financed transfers of residential real estate to a "transferee entity" (such as LLCs, corporations, or partnerships) or "transferee trust." Only one report is required for each reportable transfer, and rules provide which of the professionals would be required to file the report for particular situations. The purpose of these reporting requirements is to combat and deter money laundering through residential real estate transfers.

Residential real estate for this purpose would include single-family homes, townhouses, condominiums, and cooperatives, as well as buildings designed for occupancy by one to four families and would also include land that is vacant or unimproved but that is zoned, or for which a permit has been issued, for occupancy by one to four families.

Most types of trusts, domestic or foreign, would be included. The proposed rules specifically refer to revocable trusts. Why trusts?

> … FinCEN believes that non-financed residential real estate transfers to trusts present a high risk for money laundering. The reporting of all non-financed transfers of residential real estate in which the transferee is a trust would provide data relevant to a possible violation of law or regulation.

The reporting requirement applies regardless of the size of the sales transaction (including for gift transactions) as well as long as the transaction is a non-financed transfer.

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

> The proposed rule would collect information about the beneficial owners of trusts, defined as any individual who, at the time of the real estate transfer to the trust: (1) is a trustee; (2) otherwise has authority to dispose of transferee trust assets, such as may be the case with a trust protector; (3) is a beneficiary who is the sole permissible recipient of income and principal from the transferee trust or who has the right to demand a distribution of, or to withdraw, substantially all of the assets of the transferee trust; (4) is a grantor or settlor of a revocable transferee trust; or (5) is the beneficial owner of a legal entity or trust that holds one of the positions described in (1)-(4), taking into account the exceptions that apply to transferee entities and transferee trusts.

Various exceptions apply including certain transfers involving an easement and transfers that occur as the result of the death of the property's owner, that are the result of a divorce, or that are made to a bankruptcy estate. The preamble specifically mentions transfers to a testamentary trust following the owner's death as an exempted transaction.

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

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

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

Similar legislation was not introduced in 2023.

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

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

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

9. Estate Planning for Moderately Wealthy Clients

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

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

(1) **Transfer Tax.** The estate and gift exclusion amount and GST exemption amount is $10 million indexed for 2018-2025 ($13.61 million in 2024). This amount will decrease to $5 million indexed in 2026 (about $7.5 million in 2026) unless Congress acts to prevent that decrease. The rate on transfers not covered by the exclusion/exemption amounts is 40%. As a result of the large exclusions, many moderate estates have no transfer tax concerns. (But beware that trusts created by clients with moderate estates can still be subject to the 40% GST tax if GST exemption is not allocated to the trust, which may happen automatically in many situations, but the planner must assure that GST exemption is allocated to be protected by the exemption.) For non-resident alien individuals, however, the exclusion amount has not been increased and remains at only $60,000.

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

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

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

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

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

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

beneficiaries, charitable intent, tolerance for complexity, desire for control, and view of the "permanency" of tax laws.

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

- Fundamental tools (wills, revocable trusts, durable powers of attorney, medical powers of attorney, directives to physicians/living wills, Physicians Orders for Life-Sustaining Treatment (POLST), authorization for disclosure of protected medical information, declaration of guardian for children, declaration of guardian for oneself, appointment of agent for disposition of remains, organ and body donation, and coordinating non-probate assets such as life insurance or retirement plans)
- Outright gifting
- Intra-family loans
- Irrevocable life insurance trusts
- Spousal limited access trusts (SLATs) (sometimes referred to as spousal lifetime access trusts)
- Grantor retained annuity trusts (GRATs)
- Sales to grantor trusts (sometimes referred to as intentionally defective grantor trusts)
- Accidentally perfect grantor trusts
- Charitable gifts
- Using IRAs for charitable gifts
- Donor advised funds
- Portability planning in connection with bypass trusts and marital trusts

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

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

(2) **Portability Planning.** Many moderately wealthy clients will want to rely on portability and leave assets at the first spouse's death either outright to the surviving spouse (and rely on disclaimers if a trust is desirable) or to a QTIP trust with a Clayton provision (which allows the most flexibility). However, a credit shelter trust approach may be appropriate for some moderately wealthy clients. For a detailed discussion of planning considerations, including major factors in bypass planning versus portability, methods of structuring plans for a couple to maximize planning flexibilities at the first spouse's death, ways of using the first decedent-spouse's estate exemption during the surviving spouse's life, whether to mandate portability, whether to address who pays filing expenses to make the portability election, state estate tax planning considerations, and the financial impact of portability planning decisions, see Item 5 of the Current Developments and Hot Topics Summary (December 2015) found **here**, Item 8 of the Current Developments and Hot Topics Summary (December 2013) found **here**, and Item 3 of Heckerling Musings 2018 and Estate Planning Current Developments (April 2018) found **here**, all available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(3) **Transfer Planning.** Individuals with over about $7.5 million or couples with over $15 million will need to decide whether to take steps to utilize the larger ($13.61 million in 2024) gift exclusion amount to make gift tax-free transfers before the exclusion amount may decrease in 2026 to about $7.5 million. (Some planners refer to the excess exclusion that may be lost in 2026 as the "bonus exclusion.") For a discussion of transfer planning alternatives, see Item 8 of Estate

Planning Current Developments and Hot Topics (May 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

(5) **SLATs.** A married individual may consider making the gift to a trust of which the spouse is a discretionary beneficiary in case of "rainy days" needs. For a detailed discussion of SLATs and "non-reciprocal" SLATs, including a discussion of the §2036 and §2038 issues and creditor issues, see Items 78 and 80 of the ACTEC 2020 Annual Meeting Musings (March 2020) found **here**, Item 10.i. of Estate Planning Current Developments and Hot Topics (December 2019) found **here**, and Item 16 of the Current Developments and Hot Topics Summary (December 2013) found **here**, all available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** For a discussion of potential conflicts of interest between spouses and creditor concerns with SLATs, see Item 10.e of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** *See generally* George Karibjanian, *Exploring the "Back-End SLAT" – Mining Valuable Estate Planning Riches or Merely Mining Fool's Gold?*, 47 BLOOMBERG TAX MGMT. ESTS., GIFTS & TRUSTS J. NO. 6 (Nov. 10, 2022).

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

(7) **Basis Adjustment Planning.** Basis adjustment planning will be appropriate for many clients. They and their family members may not have estate tax concerns given the higher exclusion amounts even if trust assets are included in their estates, and basis adjustment planning may be appropriate for assets that may qualify for a stepped-up basis at the person's death under §1014 (assuming §1014 is not repealed). Four basic approaches can be used to cause estate inclusion of trust assets in a beneficiary's gross estate, and therefore a basis adjustment:

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

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

(3) using a formula general power of appointment for the beneficiary (as was done in PLR 202206008, discussed in Item 19.a of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**); or

(4) triggering the "Delaware tax trap."

For a general discussion of each of these planning approaches, see Item 7 of Estate Planning: Current Developments and Hot Topics (December 2014) found **here**, and for a detailed discussion of various basis adjustment planning alternatives (including various form provisions), see Item 5 of the Estate Planning Current Developments Summary (December 2018) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** For a brief summary of drafting considerations, see Item 19.b(2) of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

One way of applying the general power of appointment approach is utilizing otherwise unused exclusion amounts of parents or grandparents with what has become known as "upstream planning." *See* David A. Handler & Christiana Lazo, *Senior Powers of Appointment*, TRUSTS & ESTATES 14 (Sept. 2020). Upstream Planning is discussed Item 7.c of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at

www.bessemertrust.com/for-professional-partners/advisor-insights. *See* Mickey Davis & Melissa Willms, *Estate Planning for Modest Estates: Practical Tools Every Planner Should Know,* 58TH HECKERLING INST. ON EST. PL., at Section III.I (2024) ("accidentally perfect grantor trusts"); Turney Berry, *The "Hook" of Increased Income Tax Basis*, TRUST & ESTATES 10 (April 2018).

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

(9) **State Estate Taxes**. For planning in states with state estate taxes (17 states and the District of Columbia have state estate and/or inheritance tax)), using multiple QTIP trusts may be helpful if the state recognizes QTIP trusts that are effective for state purposes only. In addition, the exclusion amount at the state level may is not portable (except in Hawaii and Maryland), necessitating additional planning in states with state estate taxes.

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

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

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

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

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

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

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

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

(8) **Diversified Portfolio With Typical Turnover.** For clients with a diversified portfolio with typical turnover for a diversified portfolio, whether a basis step-up is available at the second spouse's

death is not overly significant. (Gains are realized significantly during the surviving spouse's lifetime, and there is not a great deal of unrealized appreciation that would lose the benefit of a basis step-up.)

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

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

a. **Significance.** The gift/estate exclusion amount is scheduled to revert from $10 million (indexed) to $5 million (indexed) in 2026, so a shrinking window of opportunity is available for making use of the larger exclusion amounts with lifetime gifts. Mid to late 2025 could be a very busy time for transfer planning as we wait to see whether legislation will be enacted to extend the $10 million (indexed) exclusion amount. A practical problem for transfers made in late 2025 is that the planners will not have time to get appraisals before the end of 2025, and some kind of formula transfer may be necessary.

Furthermore, many clients are extremely reluctant to pay current gift taxes. Perhaps the most important advantage of the increased gift tax exclusion amount for many individuals is the "cushion" effect – the ability to make gifts in excess of $5 million, but considerably less than $13,160,000 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even for assets whose values are very uncertain). But for large transfers of hard-to-value assets approaching the client's remaining gift exclusion amount, defined value formula transfers are commonly used in light of inherent valuation uncertainties.

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

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

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

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

(4) **Price Adjustment (*King*).** Price adjustment clauses adjust the price rather than the amount transferred in a sale transaction *(King*; but *McLendon* and *Harwood* did not recognize price adjustment clauses; an advantage of price adjustment clauses is that a "re-transfer/re-titling" of assets is not required after the correct value is determined) (Example: "I hereby sell 100 shares of the Company in exchange for a promissory note with a principal amount of $[X] (which the parties believe to be equal to the fair market value of the shares). The term of the promissory note shall be [add note terms/interest]. If the fair market value of the shares as finally determined for federal gift tax purposes is greater or less than $[X], the principal amount of the note shall be

adjusted to the finally determined value effective as of the date of the transfer. The parties intend for the sale to be at fair market value and that no gift result from the sale.").

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

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

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

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

- Public Charity/Donor Advised Fund – This approach is more conservative than other alternatives; the recipient of the excess amount has a fiduciary obligation; this type of donee was blessed in *McCord*, *Hendrix*, *Petter*, and *Christiansen*;
- Private Foundation – This is more cumbersome because the self-dealing and excess benefit rules apply;
- Lifetime QTIPs – A gift tax return will have to be filed making the QTIP election before knowing what assets are in the QTIP trust;
- GRAT (for both lifetime QTIPs and GRATs, consider having different trustees and some differences in the beneficiaries compared to the trust that is the initial recipient of the formula transfer so that independent fiduciary obligations exist; it is not clear how a GRAT could meet the requirement to make annuity payments within 120 days of the due date for annuity payments during the period of uncertainty as to what assets have been conveyed to the GRAT; see Item 13.b(2) below for other comments about using a GRAT as the spillover recipient); and.
- Spouse – The excess amount could pass outright to the donor's spouse.

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

(2) ***Wandry* Clause.** The *Wandry* approach is simpler because it does not involve a third-party recipient, but it loses the benefit of a third-party trustee with independent fiduciary obligations, and it could result in fewer shares being transferred. See Item 10.d below for a discussion of IRS arguments made against a *Wandry* transfer in *Sorensen v. Commissioner*.

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

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

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

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

(4) **Combined *Wandry*/*King* Approach.** In addition, a combined *Wandry*/consideration adjustment approach could be used (sometimes referred to as a two-tiered *Wandry* transfer). The client would make a traditional *Wandry* transfer of that number of units that is anticipated to be worth the desired transfer amount (which could either be a gift or a sale), but with a provision that if those units are finally determined for federal gift tax purposes to be worth a higher value, the shares that were not transferred because of the *Wandry* provision would be sold for a note as of the same date as the *Wandry* gift, with the price being determined by the finally determined gift tax value. *See* Joy Matak, Steven Gorin & Martin Shenkman, *2020 Planning Means a Busy 2021 Gift Tax Return Season*, LEIMBERG ESTATE PLANNING NEWSLETTER #2858 (February 2, 2021) (includes excellent suggested detailed disclosures for reporting a two-tiered *Wandry* transfer on a gift tax return and income tax return, including Schedule K-1 disclosures).

That approach was used in *True v. Commissioner* (Tax Court Docket Nos. 21896-16 & No. 21897-16), which cases were settled on a basis that, as reported in Tax Court filings, appears favorable for the taxpayer. The father made transfers of assets worth well over $160 million under these clauses (any gifts were deemed to be made equally by the spouses under the split gift election). The IRS determined that the transfers resulted in additional gifts by the parents collectively of

$94,808,104 resulting in additional combined gift taxes of 35% of that amount, or $33,182,836. The taxpayers avoided that horror show and ended up paying only an additional $4,008,642 (combined) of gift tax under stipulated decisions filed in both cases in July 2018. The taxpayers no doubt viewed an additional current outlay of about $4 million rather than $33 million as a huge victory (even if the audit may have resulted in additional value being included in the parents' estates under revised face amounts of notes). For a discussion of *True v. Commissioner*, see Item 8.c(17) of Aucutt, *Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts* (September 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

(6) **Some Planning Issues.**

- The IRS looks at these cases closely, but largely to determine whether the clause was implemented properly. No pre-arrangements should exist.
- Documentation should be consistent in all respects with the formula transfer. (See the discussion in Item 10.d(3) below about documentation tips based arguments raised in *Sorensen v. Commissioner*.)
- With a *Petter* or *Wandry* type of formula (based on values as finally determined for gift tax purposes) it is essential that a gift tax return be filed.
- The recipient trusts should be grantor trusts; if adjustments are made following an audit, no income tax return amendments should be necessary because all of the income is taxed to the grantor in any event.

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

(1) **Basic Facts.** Chris and Robin Sorensen grew up in a firefighter family. Their father was a firefighter. They loved joining in communal meals at the firehouse, and Robin decided at a young age that one day he would open a restaurant. Eventually, the brothers scrounged $28,000 in loans from family members and in 1994 started a sandwich shop (because it required the least capital investment compared to other restaurants).

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

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

> equal to $5,000,000, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or court of law.

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

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

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

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

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

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

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

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

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

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

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

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

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

(4) **Settlement.** A Stipulation of Settled Issues reached the following conclusions:

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

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

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

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

(5) **Observations.**

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

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

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

(b) **Values.** The values resulting from the settlement ($1,640 per share for the gift and $1,722 per share for the sale) were much closer to the IRS's position that the shares were worth

about $2,000 per share than the donors' appraised value of about $500 per share. Query how much of that added value was attributable to not allowing tax affecting of the S corporation shares?

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

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

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

(f) **Reporting Consistency.** As discussed in Item 10.d(3) above, planning tips can be gleaned from the IRS arguments in *Sorensen* for structuring and documenting the transfer of shares in satisfaction of the formula assignment before the time that a final determination of gift tax value is made, including documentation regarding the stock ledger, distributions, and the sale to the third party as well as having the donee specifically acknowledge the formula transfer on the stock power.

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

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

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

(6) **Resources.** For a more detailed discussion of the IRS arguments in *Sorensen*, see Item 13.c of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** For a more detailed discussion of defined value clauses, see Item 14 of the Current Developments and Hot Topics Summary (October 2017) found **here** and Item 8.c. of Aucutt, *Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts* (September 2023) found **here,** both available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

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

a. **Anticipate Disputes.** Prepare for audits and litigation at the planning stage. The IRS issues broad discovery requests. (Example: "All documents relating to the creation of the entity from any attorney,

accountant or firm involved in recommending the creation of the entity.") The planner's files can be subpoenaed, including emails.

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

b. **Common IRS Challenges.** Common IRS challenges involve valuation, formula transfers, QTIP termination, promissory notes, sales to grantor trusts, GRATs, penalties, §2036, or split-dollar life insurance. Life insurance transfers can also create challenges. See Items 31 and 32 below for a discussion of recently settled cases (*DeMatteo* and *Cinader*) regarding life insurance valuation issues.

c. **Valuation—Cases Giving No Weight to Liquidation Value.** The recent *Cecil* case (see Item 25 below) held that no weight was given to the liquidation value of a company when the transferred interests had no ability to force the liquidation of the company, and the company had a long history suggesting that it would not be liquidated. Other cases involving that same issue are *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101 "(income-based approach … is more appropriate than … NAV method valuation"); *Estate of Giustina v. Commissioner*, 586 Fed. Appx. 417 (9th Cir. 2014) (in valuing an interest in a timber partnership that could not unilaterally force liquidation, applying 25% likelihood to possibility of liquidation was clearly erroneous, despite the hypothetical possibility that the owner of that interest could form a voting bloc block with other limited partners to liquidate); *Estate of Dunn v. Commissioner*, 301 F.3d 339 5th Cir. 2002) (court applied 85/15 earnings-based to asset-based weighting ratio rather than the lower court's 35/65 weighting considering that the company was a going concern that would be purchased for continued operation, not liquidation or other asset disposition); *Estate of Watts v. Commissioner*, 823 F.2d 483 (11th Cir. 1987) (15% interest in general partnership with timberland that could not force liquidation was valued based on its going concern value, not its liquidation value; conclusion based on absence of right to force liquidation "because of legal restriction placed upon the partners' interest by contract, fully commensurate with Oregon law," not on the remaining partners' intent to continue the partnership).

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

e. **QTIP Termination.** The IRS is increasingly reviewing planning with assets in QTIP trusts, including the termination of QTIP trusts followed by transfer planning transactions by the spouse with assets that had been in the QTIP trust. See Item 29 below.

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

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

In addition, the IRS reviews the proper application of §7872 to the note. Under §7872, below market loans that are gift loans may result in a deemed gift from the lender to the borrower and a deemed interest payment from the borrower to the lender. A note that arises from a sale for full consideration may not be subject to §7872 as a gift loan. Money loans are not subject to the complex OID rules. (See Item 22 below.)

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

- One of the major advantages of GRATs is that a formula, based on the finally determined value of contributed assets, can be used to set the retained annuity payments, thereby "eliminating" the risk of a surprise gift upon the creation of a GRAT. (But see Item 13.a below regarding CCA 202152018.)
- A GRAT can be structured so that no taxable gift results from its creation, so GRATs can be used by donors who have no gift tax exclusion remaining.
- When the GRAT funding is reported on a gift tax return, elect out of automatic GST exemption allocation. (The estate tax inclusion period (ETIP) does not end until the GRAT term ends.)

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

- Do terms of the GRAT agreement comply with the §2702 regulations?
- Has the GRAT been operated in accordance with its terms?
- Are the assets contributed to the GRAT properly valued? (See *Grieve v. Commissioner,* T.C. Memo. 2020-58. CCA 202152018, and *Baty v. Commissioner* are discussed in Item 13.a below).
- Is a consistent valuation methodology being used for the initial valuation and for annuity payment valuations or exercises of substitution powers? (Consider using a *Wandry* or *King* type formula approach for annuity payments or exercises of substitution powers, although the use of a *Wandry* or *King* clause will require the filing of a gift tax return.)
- Have all annuity payments been made timely?
- The IRS is taking a hard line on operational issues. IRS representatives in some cases have argued that the GRAT was not a qualified interest under an *Atkinson* analysis, similar to the position publicized in CCA 202152018 (which is discussed in Item 15.a below).

i. **Sales to Grantor Trusts.**

(1) **Gift Tax Issues.**

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

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

- **Sufficient Seeding.** The IRS should lose this argument if the trust is seeded with significant value or if the trust has a guarantee backed by a guarantor who can pay the guarantee if necessary. *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), was a private annuity case which did not result in estate inclusion where the promise to pay the annuity was a personal obligation, not just payable out of earnings, and the size of payments was not based on the amount of income from transferred assets. The government made similar arguments in the *Woelbing* and *Beyer* cases. For a discussion of *Woelbing*, see Item 8.c(16) of Aucutt, *Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts* (September 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**
- **Collapsing Gift and Sale.** If the gift and sale happen the same day (or are deemed to be part of an integrated transaction) the IRS may argue that all the transferred assets have some gift element, so the bona fide sale for full consideration exception in §2036 and §2038 is inapplicable. *Cf. Pierre v. Commissioner*, T.C. Memo. 2010-106 (2010) (step transaction doctrine applied to collapse 9.5% gift and 40.5% sale, made at approximately the same time, to each trust for valuation purposes.)

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

predeceases the client) in a manner that is excluded from the estate for federal and state estate tax purposes.

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

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

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

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

(3) **Resources.** For a detailed discussion of SLATs and "non-reciprocal" SLATs, including a discussion of the §2036 and §2038 issues and creditor issues, see Items 78 and 80 of the ACTEC 2020 Annual Meeting Musings (March 2020) found **here**, Item 10.i. of Estate Planning Current Developments and Hot Topics (December 2019) found **here**, and Item 16 of the Current Developments and Hot Topics Summary (December 2013) found **here**, all available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** For a discussion of potential conflicts of interest between spouses and creditor concerns with SLATs, see Item 10.e of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** *See generally* George Karibjanian, *Exploring the "Back-End SLAT" – Mining Valuable Estate Planning Riches or Merely Mining Fool's Gold?*, 47 BLOOMBERG TAX MGMT. ESTS., GIFTS & TRUSTS J. NO. 6 (Nov. 10, 2022).

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

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

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

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

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

Section 2036(a)(2) and the "alone or in conjunction with" analysis has been the focus in the last several years following the *Powell* case. For a discussion of *Powell*, *Cahill*, *Morrissette*, and *Levine* regarding the §2036(a)(2) issue, see Item 17 of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

(2) **Summary of §2036 FLP/LLC Cases (14-24, with 2 Cases on Both Sides).** For a summary of the various FLP/LLC cases that the IRS has chosen to litigate under §2036, see Item 9.f of Estate Planning Current Developments (March 16, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

(4) **Bona Fide Sale for Full Consideration Defense.** The bona fide sale for full consideration defense is the best defense to any §2036 attack. Planners should accordingly consider documenting the purposes of transfers to entities at the time of the creation of the entities. John Porter points out that factors that have been applied in finding that a "significant and legitimate non-tax reason" (*Bongard*) existed under a case-by-case for an entity are:

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

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

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

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

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

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

Case	Assets	Court	Discount from NAV/ Proportionate Entity Value
Strangi I (2000)	Securities	Tax	31%
Knight (2000)	Securities/real estate	Tax	15%
Jones (2001)	Real estate	Tax	8%; 44%
Dailey (2001)	Securities	Tax	40%
Adams (2001)	Securities/real estate/minerals	Fed. Dist.	54%
Church (2002)	Securities/real estate	Fed. Dist.	63%
McCord (2003)	Securities/real estate	Tax	32%
Lappo (2003)	Securities/real estate	Tax	35.4%
Peracchio (2003)	Securities	Tax	29.5%
Deputy (2003)	Boat company	Tax	30%
Green (2003)	Bank stock	Tax	46%
Thompson (2004)	Publishing company	Tax	40.5%
Kelley (2005)	Cash	Tax	32%
Temple (2006)	Marketable securities	Fed. Dist.	21.25%

Case	Assets	Court	Discount from NAV/ Proportionate Entity Value
Temple (2006)	Ranch	Fed. Dist.	38%
Temple (2006)	Winery	Fed. Dist.	60%
Astleford (2008)	Real estate	Tax	30% (GP); 36% (LP)
Holman (2008)	Dell stock	Tax	22.5%
Keller (2009)	Securities	Fed. Dist.	47.5%
Murphy (2009)	Securities/real estate	Fed. Dist.	41%
Pierre II (2010)	Securities	Tax	35.6%
Levy (2010)	Undeveloped real estate	Fed. Dist. (jury)	0 (valued at actual sales proceeds with no discount)
Gallagher (2011)	Publishing company	Tax	47%
Koons (2013)	Securities	Tax	7.5%; Estate owned 70.42% of voting interests and could remove limitation on distributions
Richmond (2014)	Marketable securities	Tax	46.5% (37% LOC/LOM & 15% BIG)
Giustina (2016)	Timberland; forestry	Tax	25% with respect to cash flow valuation (Tax Court applied 75% weight to cash flow factor and 25% weight to asset value method); BUT reversed by 9th Circuit and remanded to reconsider without giving 25% weight to asset value method)
Streightoff (2018)	Securities	Tax	0% lack of control discount because the 88.99% LP interest could remove the general partner and terminate the partnership; 18% lack of marketability discount
Kress (2019)	Manufacturing	Tax	Lack of marketability discounts of 25% for 2007-2008 gifts & 27% for 2009 gifts (those numbers include 3% downward adjustment because a family transfer restriction was not taken into account); additional adjustment for minority interest in non-operating assets
Jones (2019)	Sawmill & timber	Tax	35% lack of marketability discount from value of noncontrolling interest
Grieve (2020)	Securities	Tax	35% for one LLC and 34.5% for another LLC (98.8% non-voting LLC interest)
Nelson (2020)	FLP owned 27% of holding company that owned various subsidiaries with operating businesses	Tax	FLP's interest in holding company valued with 15% lack of control discount and 30% lack of marketability discount (combined 40.5% discount); transferred limited partner interest in FLP valued with 5% lack of control discount and 28% lack of marketability discount (combined 31.6% discount)
Warne (2021)	Majority interests in five LLCs (each over 70%) owning real estate	Tax	Four majority LLC interests not passing to charity: 2% lack of control discount (court might have found no LOC discount but parties agreed some LOC discount was proper) and 5% lack of marketability

Case	Assets	Court	Discount from NAV/ Proportionate Entity Value
			discount; One wholly owned LLC interest passing to two charities: for charitable deduction, parties stipulated a 4% discount for a 75% LLC interest and 27.385% discount for a 25% LLC interest
Smaldino (2021)	Ten rental real estate properties	Tax	36% combined lack of control and marketability discount (accepting view of IRS expert) for transfers of minority nonvoting interests

Adapted from John Porter, A View from the Front Lines – Current Issues in Estate and Gift Tax Audits and Litigation, 58TH ANN. HECKERLING INST. ON EST. PL. (2024); John Porter, *A View from the Trenches: Current Issues in Estate and Gift Tax Audits and Litigation,* 56TH ANN. HECKERLING INST. ON EST. PL. (2022).

m. **Valuation Penalties; *Morrissette*.** *Morrissette* (discussed in Item 17.c(3) and Item 20 of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**) applied undervaluation penalties even though the taxpayer secured appraisals from a reputable appraiser. The court did not question the credentials of the appraiser but said that the taxpayer was unreasonable in relying on the appraisal. The "legal advice defense" was waived by asserting attorney-client privilege. The court observed that the intergenerational split-dollar transaction was marketed as a way to undervalue rights and noted that the taxpayer recommended changes to the appraiser's report. Accuracy-related penalties under §6662 and failure to file and pay penalties under §6651 were avoided in *Huffman v. Commissioner* because of the reasonable reliance on professional advice, as discussed in Item 30 below.

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

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

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

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

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

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

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

- Can be satisfied by substantial compliance; and
- Are not mandatory, but act as guidance to inform donors on a way to satisfy adequate disclosure.

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

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

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

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

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

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

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

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

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

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

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

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

(2) **Statute.** If a gift is not reported on a gift tax return, gift taxes may be assessed at any time. The statute provides an exception for "any item which is disclosed in [a gift tax return], or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item." §6501(c)(9). A similar statement is in the statute for the six-year limitations period

that applies if omitted gifts exceed 25 percent of the gifts reported on a gift tax return. The six-year limitations period does not apply to any item "disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the [IRS] of the nature and amount of such item." §6501(e)(2). The court summarized the "essence" of the statute as providing the IRS "with a viable way to identify gift tax returns that should be examined with minimum expenditure of resources. T.D. 8845, 1999-2 C.B. 683."

(3) **Cases.** Cases generally have looked to the purpose of disclosure, and whether disclosure is sufficient to alert the IRS whether to select a return for examination. *See Thiessen v. Commissioner*, 146 T.C. 100, 114 (2016) (quoting *Estate of Fry v. Commissioner*, 88 T.C. 1020, 1023 (1987) (cited in the *Schlapfer* opinion). **[Observation:** These are income tax cases addressing the application of the adequate disclosure exception in §6501(e)(1)(B)(iii) for purposes of the six-year limitations period where there is an omission of more than 25% of gross income. Both cases found that the taxpayer had not adequately disclosed omitted income. See Item 12.e(3) below regarding case discussions.]

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

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

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

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

Reg. §301.6501(c)-1(f)(2).

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

> Furthermore, the Treasury Regulations provide that *[First Sentence]* "[a] transfer will be adequately disclosed … *only if* it is reported in a manner adequate to apprise the [IRS] of the nature of the gift … *[Second Sentence]* Transfers reported on the gift tax return as transfers of property by gift *will be* considered adequately disclosed … if the return … provides the following information." Treas. Reg. §

> 301.6501(c)-1(f)(2) (emphasis added). The difference between the wording used in these two sentences informs us that the requirements are not mandatory, but act as guidance to taxpayers to inform them on a way to satisfy adequate disclosure. (Emphasis in original.)

Observation: The court's description of the first sentence of the regulation (with its "only if" statement) sounds like the description of a general rule, and the description of the second sentence (with its "will be considered adequately disclosed" statement) sounds like a safe harbor, although the court did not use those precise terms. Indeed, the court refers to the elements of what many regard as a safe harbor in the second sentence as "requirements," albeit "requirements" that it views as "not mandatory" but only as guidance of what is "sufficient to alert the [IRS] to the nature of the gift." The opinion makes no reference to the appraisal safe harbor, which is an objective way of supplying the information required in subparagraph (iv) of Reg. §301.6590(c)-1(f)(2) about the method used to value the property.

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

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

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

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

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

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

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

nature of the gift. Because this description was sufficient to alert the Commissioner to the nature of the gift, Mr. Schlapfer substantially complied with this requirement.

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

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

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

e. **Observations.**

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

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

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

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

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

(b) **No Requirement To Pay Gift Tax To Commence Period of Limitations.** Prior to the 1997 Act, the three-year statute of limitations, for assessment of gift tax and for determining the amount of gifts in preceding calendar quarters, would begin to run on gifts in a year in which a gift tax return was filed *and gift tax was paid*. §2504(c). Effective for gifts made after August 5, 1997, the requirement of paying gift tax for the statute of limitations to begin running was deleted.

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

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

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

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

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

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

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

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

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

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

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

The regulation for non-gift transactions states that the transfer will be considered adequately disclosed "only if" (1) information in four of the five items in the second sentence of Reg. §301.6501(c)-1(f)(2) are provided (the items other than valuation information) and (2) an explanation states why the transfer is not a gift. Reg. §301.6550(c)-1(f)(4). Thus, under the regulations the four items are not merely a safe harbor but must be provided to constitute adequate disclosure of a non-gift transaction. They are (i) description of the transferred property and any consideration received, (ii) identity and relationship of the transferee, (iii) specified information about the trust recipient if the transfer is made to a trust, and (iv) a statement describing any position contrary to regulations or rulings published before the transfer. Interestingly, valuation information is not required, even though it would seem to be very relevant in determining whether a sale was for full consideration so that the transfer was a non-gift transaction.

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

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

13. GRAT Planning Alternatives; Drafting and Administering Flexible GRATs

The following observations are from presentations by Diana Zeydel (Miami, Florida) and Jonathan Blattmachr (Garden City, New York).

a. **Tips for Avoiding Argument Large Gift Was Made.** In CCA 202152018, the donor transferred shares of a company to a GRAT and used an appraisal that was seven months old and did not take into account ongoing merger discussions. The company ultimately sold for three times the appraisal value that was used to calculate the annuity amounts. The CCA cited the *Atkinson* case where a gift to a charitable remainder annuity trust did not qualify for a charitable deduction because the annuity payments were not made on time (*Atkinson v. Commissioner*, 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002)). The IRS analogized *Atkinson* to this case, disqualifying the GRAT altogether for lack of a qualified annuity interest, finding that the taxpayer intentionally used an undervalued appraisal and therefore never intended to retain a qualified annuity interest. The result was that the donor was deemed to have made a gift of the full value transferred to the GRAT. Many commentators do not agree with this CCA or the application of the *Atkinson* case in the GRAT context, but it is still cautionary. For a detailed discussion of CCA 202152018, CCA 201939002 (which was similar), and *Baty v. Commissioner* (which involved the case addressed by CCA 201939002), see Item 18 of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

The following are ideas for drafting defensively against the possibility that an inaccurate appraisal or mistakes in the administration of the GRAT may create very adverse gift tax consequences.

(1) **Formula Annuity Payments**. Instead of defining the annuity as a stated dollar amount or a fraction or percentage of the value of the assets used to fund the GRAT, establish the annuity by using a formula. Diana Zeydel provides sample language for a formula essentially stating that the first-year annuity is an amount that if, increased by 20% annually, causes the remainder to be worth 1% of the fair market value of the initial contribution. Does this qualify as a "stated dollar amount" or "fixed fraction or percentage of the initial fair market value of the property" as required under Treas. Reg. §25.2702-3(b)(1)(ii)? Ms. Zeydel involves an actuary each time she prepares a GRAT to run the calculation and confirm that it qualifies as a percentage of the initial fair market value.

(2) **Nominee Concept if Deadline Missed**. Treas. Reg. §25.2702-3(b)(4) provides that "[a]n annuity amount payable based on the anniversary date of the creation of the trust must be paid no later than 105 days after the anniversary date." To hedge against the risk that annuity payments are not paid on time or are not made fully due to valuation issues, consider including provisions in the trust agreement that terminate the trust as to the amount that should have been distributed and convert the capacity in which such assets are held from a trustee capacity to a mere nominee capacity holding the assets for the beneficiary. Ms. Zeydel provides sample language for this protective clause.

(3) **Avoiding Inadvertent Additional Contributions**. Treas. Reg. §25.2702-3(b)(5) prohibits additional contributions from being made to a GRAT after its initial funding. Most GRAT agreements contain a savings clause stating that if additional contributions are made after the date of initial funding, those assets automatically create a new GRAT. Two additional planning options may be used to protect against an accidental late contribution. First, the grantor can contribute all assets intended to be transferred to a GRAT to a single-member LLC first. Once the LLC is fully funded, the grantor assigns that LLC to the GRAT. Second, start with a revocable trust agreement and move the intended GRAT assets into the revocable trust, which would be incomplete gifts. Once all assets are funded into the GRAT, the grantor releases the power to revoke the trust, completing the gift and ensuring no assets are transferred late.

b. **Other Unique GRAT Planning Techniques.**

(1) **Qualifying GRAT for Marital Deduction.** If the grantor dies during the term of a short-term GRAT, the entire value of the trust assets (or at least most of it) will probably be included in the grantor's estate. If the grantor is married, the grantor may want the GRAT to qualify for the marital deduction under such circumstances. Drafting for this can be tricky as you must avoid any type of reversionary interest that would cause estate tax inclusion must be avoided under all scenarios.

To qualify for the marital deduction, the trust agreement should state that in the event the grantor dies during the term, the trustee is required to distribute the greater of the annuity payments and the income to the grantor's estate. This structure is permitted under Treas. Reg. §25.2702-3(b)(1)(iii). The grantor also needs to provide in the grantor's will that any income received by the estate from the GRAT shall be paid to the grantor's spouse. Some commentators feel that the entire annuity payment (in excess of income) must be paid to the surviving spouse, but the speakers concluded that this is not necessary, looking to Revenue Ruling 89-89 by analogy (applicable in the retirement account context). The excess annuity payment can instead go to a marital deduction trust. Lastly, the trust continuing at the end of the GRAT term must also qualify for the marital deduction under traditional marital deduction qualification principles.

Another drafting consideration is whether to apportion the estate taxes away from the GRAT during the annuity term to avoid the risk of violating the requirement that annuity payments may not be made to anyone other than the annuitant or the annuitant's estate. This means expressly denying rights of recovery under IRC §2207A and §2207B. Lastly, consider whether prohibiting

the use of the 105-day grace period could protect against an issue with the income being paid to the surviving spouse at least annually as required under IRC §2056.

(2) **Using GRATs Defensively with Gift Planning.** In the event a taxpayer is contemplating making a gift of difficult to value assets to a grantor trust and wishes to protect against tax implications of a valuation adjustment, the taxpayer could utilize a formula allocation clause with a GRAT as the spillover recipient. Such a formula allocation approach to deal with potential valuation adjustments has generally been accepted by the IRS (although the litigated cases have dealt with a spillover to charity, as opposed to a GRAT). One tip with this approach is to provide initial funding of the spillover GRAT contemporaneously with the initial gift to the grantor trust so that there is no uncertainty of whether the GRAT is funded and whether annuity payments are required. That way annuity payments will be required to be made, creating payments that can be adjusted using typical adjustment clauses if the annuity is finally determined to be incorrectly computed. See Item 10.c(1) above for additional comments about using a GRAT as the spillover recipient.

(3) **Split Purchase GRAT**. Potentially the biggest drawback of GRATs is that they are not efficient for GST tax planning purposes. A split purchase GRAT may be a way to allocate GST exemption to the GRAT remainder interest. The way to structure this transaction is explained in Jonathan Blattmachr & Georgiana Slade, *GRATs and SPLATs*[sm], THE CHASE REVIEW (Oct. 1994). It involves one taxpayer purchasing the annuity stream and a GST-tax-exempt trust purchasing the remainder interest. The speakers questioned whether a BDIT could be the perfect GST-tax-exempt trust to purchase the remainder interest, noting that it could easily be structured so that the remainder interest is worth less than $5,000. (For a discussion of the BDIT transaction, see Item 31 of the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**)

c. **Financial Analysis Repudiating Common Thoughts About GRATs**. Financial analysis leads to helpful conclusions regarding different situations in which GRATs are more or less successful. These conclusions may challenge our traditional notions of what results in a successful GRAT.

(1) **Return Exceeds §7520 Rate.** A GRAT will not always be successful if its average return exceeds the 7520 rate. What matters most is the path of return. For example, if there is extreme volatility and the asset values drop drastically in year one, it would not matter if the assets recovered steeply in year two and ultimately beat the 7520 rate as an average over two years. The result would still be a failed GRAT because a majority of the assets would be used to pay the grantor the initial annuity payment. However, if the initial GRAT was immunized and those assets were then used to immediately re-GRAT, then the second GRAT could capture the steep increase in value.

(2) **Low Rates.** It is not necessarily true that GRATs only work when interest rates are low.

(3) **Increasing vs. Decreasing Annuity Rates.** Increasing annuity payments by 20% each year is not always the best option. That logically seems so because the assets are staying in trust longer, but what matters more is capturing volatility and what the grantor does with the assets after the grantor receives them. Steeply declining GRAT payments could be more effective because the grantor receives the assets quicker and can determine what to do with them next. For example, poor-performing assets can be used to re-GRAT sooner. It is akin to having a one-year GRAT. Note that the regulations currently place no limitation on declining annuity payments from GRATs, but there is a proposal aimed at limiting this. The proposed "For the 99.5 Percent Act," H.R. 2676, 118th Congress, 1st Session, Sec. 7 would apply only prospectively to GRATs created after the date of enactment, so the ability to use steeply declining GRAT payments currently still exists.

(4) **Long-Term GRATs.** We have traditionally thought that shorter-term GRATs are better due to the risk of the grantor dying during the term, but longer-term GRATs can be successful too. Turney Berry (Louisville, Kentucky) suggests using a 99-year GRAT. If interest rates increase in the

future, a long-term GRAT may yield a positive remainder value, even in the event of the grantor's death during the GRAT term.

d. **Concepts Relating to the Power to Substitute**. Because capturing volatility in GRAT assets can be the most determinative factor leading to a successful GRAT, the power to substitute can be a very useful tool.

(1) **Draft in Past Tense**. To meet the requirement in Revenue Ruling 2008-22 that the properties acquired and substituted are of equivalent value, trust agreements typically require that the trustee must ensure that the assets are of equivalent value. When trying to capture GRAT volatility, the grantor may need to act quickly in exercising the power to substitute. In order to avoid a situation where the trustee can prevent the swap until the trustee is satisfied that the assets are of equivalent value, the speakers suggested drafting in the past tense so that the trustee has the power to verify asset values after they are swapped but cannot block the substitution.

(2) **Using Debt**. Treas. Reg. §25.2702-3(b)(1)(i) prohibits the trustee of a GRAT from issuing debt in satisfaction of the annuity payment owed to the grantor. It is important to note that this prohibition only covers a trustee issuing debt and would not prohibit a grantor from exercising a power to substitute, exchanging a promissory note with a principal balance equal to the fair market value of the assets reacquired from the GRAT. If the trustee then distributed a portion of the grantor's note to pay the annuity, would that violate this rule? That would not be the "issuance of a note" by the trust, but to avoid any doubt, the grantor could repay a portion of the note sufficient to allow the GRAT to make the annuity payment with assets other than the grantor's note.

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

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

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

Some advisors think that if grantor trust status is turned off for any reason, including at the death of the grantor, gain will be recognized to the extent of the excess of the amount of the outstanding note to the grantor over the basis in the property. Suppose for example, that grantor, G, sold an asset to her grantor trust for $50 when it had a basis of zero. At the time of her death the property is worth $100 and the note is still $50. Under this point of view, which relies on *Crane v. Commissioner* and the section 1001 regulations that treat a grantor as having "transferred ownership" of assets from the grantor to the trust when a grantor trust ceases to be a grantor trust (Reg. §1.1001-2 (c) Ex.5), the grantor or the trust (which one is not clear) would have gain of a $50. Carlyn does not think this is the right answer. The regulations say the amount of non-recourse liabilities that a grantor is relieved of when she disposes of property is treated as an amount realized. But in this case, although property is disposed of when grantor trust status ends, whether it ends during the individual's lifetime or at death, nobody was relieved of any non-recourse liability, because the liability owed from the trust to the grantor never existed for income tax purposes. Only at the point of death (or at any other point that grantor trust status terminated) did the trust obligation to G spring into existence.

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

Death, TRUSTS & ESTATES 34, 34-37 (Feb. 2010); Elliott Manning & Jerome Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 BLOOMBERG TAX MGMT. ESTS., GIFTS & TRUSTS J. No. 1, 3 (Jan. 14, 1999).

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

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

There are two other possible answers to this question.

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

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

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

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

a. **Overview.** The SECURE Act made various changes regarding retirement benefits including (i) changing the required beginning date (RBD) for required minimum distributions (RMDs) (April 1 of the following year) from age 70½ to 72 (and SECURE 2.0 changes it to age 73 beginning in 2023 and to age 75 beginning in 2033), (ii) eliminating the prohibition on contributions to an IRA after age 70½ (but if an individual both contributes to an IRA and arranges for a qualified charitable distribution (QCD) between ages 70½ and 72, the IRA contribution will reduce the portion of the QCD that would

otherwise be treated as tax-free), and (most important) (iii) substantially limiting "stretch" planning for distributions from defined contribution plans and IRAs over a "designated beneficiary's" (DB's) lifetime (with several exceptions). (A DB is an individual; for example, an estate or a charity would be a non-designated beneficiary (non-DB).) Generally, much more favorable rules (allowing slower payouts) apply if a plan has DBs than if it doesn't. The SECURE Act mandates that distributions to a DB be made within 10 years following the death of the participant, with exceptions for five categories of "eligible designated beneficiaries" (EDBs). The anti-stretch provisions of the SECURE Act generally apply to owners who die after 2019.

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

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

The IRS issued proposed regulations (275 pages, no less!) to update the minimum distribution rules, including guidance regarding the SECURE Act, on February 23, 2022. REG-105954-20 (published in the Federal Register on February 24, 2022, correction published March 14, 2022 in 2022-11 I.R.B. 828). The proposed regulations reflect statutory amendments since the required minimum distribution regulations were last issued, clarify issues that have been raised in public comments and private ruling requests, and replace the question-and-answer format of the existing regulations. Among other clarifications, the regulations "clarify and simplify" the minimum distribution rules where trusts are beneficiaries. ACTEC filed extensive comments with the IRS regarding the proposed regulations on May 24, 2022 (available at **https://www.actec.org/legislative-comments/actec-submits-comments-on-proposed-regulations-irs-reg-105954-20-the-proposed-regulations-address-the-required-minimum-distribution-requirements-for-plans-qualified-under-code-section-401a-and-are/**).

The proposed regulations regarding required minimum distributions are proposed to apply for calendar years beginning in 2022, and for 2021 "taxpayers must apply the existing regulations, but taking into account a reasonable, good faith interpretation of the amendments made by sections 114 and 401 of the SECURE Act. Compliance with these proposed regulations will satisfy that requirement." Preamble to REG-105954-20 at 77-78.

As to the timing of final regulations, in January 2023, William Evans (Treasury Office of Benefits Tax Counsel) said the IRS is considering whether to delay the issuance of final RMD regulations until the provisions impacted by SECURE 2.0 could be revised. *See* Caitlin Mullaney, *Treasury Reconsidering Retirement Guidance in Wake of SECURE 2.0*, TAX NOTES TODAY FEDERAL (Jan. 27, 2023). Indeed, that delay has occurred. Notice 2023-54, issued in July 2023, provided transition relief related to the RMD age increases in SECURE 2.0 and announced that the final RMD regulations would not apply until 2024. Laura Warshawsky, IRS deputy associate chief counsel (employee benefits, exempt organizations, and employment taxes), reported at an American Bar Association Tax Section meeting that the RMD final regulations were well on their way to being completed before the enactment of SECURE 2.0. She said that the IRS is actively working on the RMD regulations, which will include final regulations as well as additional proposed regulations regarding relevant SECURE 2.0 provisions. As to the timing of the final regulations, Warshawsky quipped, "I expect I'm not the only person in the presentation today who would love to know when the final regulations will be published. But I don't know. And unfortunately, I couldn't say even if I did." S*ee* Caitlin Mulaney, *RMD Final Regs Were Halted by SECURE 2.0 Passage*, 181 TAX NOTES FEDERAL 751 (Oct. 23, 2023). Guidance in the form of questions and answers regarding certain provisions in SECURE 2.0 was released December 20, 2023, in Notice 2024-2, 2024-2 I.R.B. 316 (dated January 8, 2024).

For a detailed summary of planning issues under the SECURE Act for trusts as beneficiaries, including Natalie Choate's analysis for testing a trust beneficiary, see Item 4.d.-e. of Estate Planning Current Developments and Hot Topics (December 2023) found **here**. For a fairly detailed summary of

highlights of the proposed regulations, see Item 4.d of Estate Planning Current Developments and Hot Topics 2022 (December 2022) found **here**. For a much more detailed discussion of planning issues in light of the SECURE Act, see Item 3 of Estate Planning Current Developments and Hot Topics (December 2020) found **here**. All of those documents are available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

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

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

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

(2) **Dual Distribution Requirements; Annual Distributions and Outer Limit.** The effect is that two distribution rules apply, and **both** must be satisfied if the participant dies on or after the RBD with a DB as beneficiary:

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

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

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

(4) **Uncertainty Regarding Minimum Distribution Requirements.** The changed position created uncertainty regarding required minimum distributions beginning in 2021 for beneficiaries of plans for which the owner died on or after January 1, 2020, (meaning that the SECURE Act rules apply)

and after the owner's RBD. Notice 2022-53 and Notice 2023-54 provide that the IRS will not impose an excise tax under §4974 because of the failure to make required minimum distributions in 2021 - 2023, and if the taxpayer has already paid an excise tax for a missed distribution, the taxpayer may request a refund.

For further discussion of planning in light of the uncertainty about the RMD requirements until final regulations are issued, see Item 4.f(4) of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

d. **SECURE 2.0.** The House of Representatives passed H.R. 2954, the Securing a Strong Retirement Act of 2022 (commonly referred to as "SECURE 2.0") on March 29, 2022, by an overwhelming bipartisan vote of 414 to 5. Several similar versions were considered in the Senate, and an agreed version titled "SECURE 2.0 Act of 2022" was included in Division T of the FY 2023 omnibus spending bill, the Consolidated Appropriations Act, 2023, which was signed by the President on December 29, 2022 (i.e., the date of enactment). SECURE 2.0 is an expansive (130 pages of legislative text!) addition of a wide variety of retirement savings enhancement provisions. A very helpful Committee section by section summary of SECURE 2.0 is available at **https://www.finance.senate.gov/imo/media/doc/Secure%202.0_Section%20by%20Section%20Summary%2012-19-22%20FINAL.pdf.** A few of the added provisions are briefly summarized. More of the provisions are summarized in Item 4.i of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

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

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

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

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

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

On the other end of the environmental political spectrum, Barre Seid gave all the shares of his company to the Marble Freedom Trust, a 501(c)(4) organization that opposes efforts to fight climate

change, months before the company was sold by the nonprofit for $1.65 billion. Kenneth P. Vogel & Shane Goldmacher, *An Unusual $1.6 Billion Donation Bolsters Conservatives*, N.Y. TIMES (Aug. 22, 2022), **https://www.nytimes.com/2022/08/22/us/politics/republican-dark-money.html**.

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

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

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

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

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

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

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

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

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

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

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

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

organization might be viewed as being funded by "dark money." Others may welcome privacy as a protection from perceived harassment.)

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

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

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

(3) **Lack of Control.** This is a very significant factor for some donors. Assets includible in the gross estate that are in a 501(c)(4) organization do not qualify for an estate tax charitable deduction. If a donor retains too much control, §2036(a)2) may cause the assets contributed to the 501(c)(4) organization to be in the gross estate without an offsetting estate tax deduction. See Item 16.g(2) below for a discussion of planning alternatives around this issue.

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

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

d. **Gift Tax Considerations.**

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

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

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

990s. Alternatively, the (c)(4) organization can file Form 1024 to get a determination letter from the IRS that it is a valid (c)(4) exempt entity. Donors of large gifts will want the organization to obtain an exempt status determination letter from the IRS before making the large taxable gift.

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

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

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

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

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

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

(2) **Permissible Activities.**

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

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

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

(d) **Political Activities.** This is the hot button. This is the reason that may be a primary motivator for forming a 501(c)(4) organization. All the discussion and controversy leading up to the adoption of §2501(a)(6) focused on political activities. The regulations make clear that "[t]he promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office." Reg. §1.501(c)(4)-1(a)(2)(ii). *See* PLR 201221028. Section 501(c)(3) organizations cannot engage in any political activities. Some degree of political activity is allowed by (c)(4) entities. See Item 16.e(3) below regarding the amount of political activity that may be allowed.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

g. **Tax Pitfalls.**

(1) **Gift Tax.** Transfers to the organization will be subject to gift tax if the organization ultimately is determined not to be a valid 501(c)(3) or (c)(4) entity. Donors of large gifts will insist that the organization obtain a determination letter before making large gifts to the organization. See Item 16.d(3) above.

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

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

Two solutions are available.

(1) **Relinquish All Control.** Limit the involvement of the donor in the organization's activities sufficient to avoid triggering §2036(a)(2), such as avoiding serving as a director, trustee, or officer of the organization. (The trustee of the trusts that constitute the Patagonia founder's 501(c)(4) organization is a private trust company. Presumably, it is designed to avoid estate inclusion for the donor under §2036(a)(2). Otherwise, the estate tax bill would be in the hundreds of millions of dollars.) Avoiding estate inclusion may be possible with strategies commonly used to avoid §2036(a)(2). These include: (1) avoid holding any position that participates in distribution

decisions, (2) limit the donor's power to investment and management, not distribution, decisions; (3) limit any ability to appoint and remove directors or trustees to the appointment of independent directors and trustees; and (4) make sure the donor could never be appointed to a position holding such a tax sensitive power.

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

A potential concern is that assets of the (c)(4) organization may be aggregated with other assets in the gross estate for valuation purposes. For example, if the (c)(4) organization owned nonvoting stock and the decedent owned voting stock of the same corporation, the value of the nonvoting stock may be increased because of the voting control, but the charitable deduction may be limited to the value of the nonvoting stock without any voting control attributes. *See Estate of Warne v. Commissioner*, T.C. Memo. 2021-17.

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

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

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

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

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

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

17. Chapter 14; Application of Section 2701 to Carried Interests of Hedge Funds and Private Equity/Venture Capital Funds and to Family Office Profits Interests

The information in this Item is based on discussions by Todd Angkatavanich (New York, New York), Amy Heller (New York, New York), Kevin Matz (New York, New York), and Adam Sherman (Chicago, Illinois).

a. **Overview Comparison of Common Freeze Transactions**. A preferred interest partnership transaction is one type of estate freezing transaction that directly involves §2701. As an overview to the significance of §2701, the common freeze transactions are compared (including cash flow considerations for each).

(1) **GRAT.** The grantor can receive cash flow with annuity payments.

(a) **Pros.** Statutory and regulatory approval; self-adjustment feature for valuation of assets transferred to the GRAT.

(b) **Cons.** Cannot leverage the GST exemption generally; actuarial risk if grantor dies during the GRAT term.

(2) **Sale to Grantor Trust.** The grantor can receive cash flow with note payments.

(a) **Pros**. Can use a GST-tax-exempt structure from the outset.

(b) **Cons.** No automatic valuation adjustment feature (but a defined value formula note provision may be permissible).

(3) **Preferred Interest Partnership.** The grantor receives cash flow from the annual preferred payments. The annual preferred payments may even represent much of the income from the assets in the partnership, discussed below.

(a) **Pros.** Statutory recognition; common interest may be owned by a GST-tax-exempt trust; inside basis step up at parent's death if a §754 election is in effect; the absence of a "day of reckoning" (for GRATs, the initial value transferred must be paid back to the grantor, either in annuity payments or notes payments, but for preferred interest partnerships, the initial value contributed to the partnership is never re-transferred fully to the grantor's estate).

(b) **Cons.** The most exotic (and expensive) of the alternatives (do not suggest a preferred interest partnership until the other alternatives have been explored and rejected); higher coupon rate required on the preferred stock than the §7520 rate for GRATs or the AFR for sales to grantor trusts; more appraisals required (the preferred interest must be appraised as well as the common interest passing to the trust); if the transferee is not a grantor trust, must be concerned with partnership income tax issues (disguised sales rules and diversification rules).

(c) **Cash Flow Representing Much of the Partnership Income.** The preferred partnership transaction offers a way for a parent to make a gift while retaining most of the income from the transfer without having the assets brought back into the gross estate under §2036 (a)(1). A donor may create a partnership and retain the right to a preferred return (in a manner that complies with §2701) and give to an irrevocable trust the common interest that has the right to excess return and appreciation. The preferred return may end up being much of the income produced by the partnership; in effect the donor is making a gift of future appreciation (to the extent the partnership grows above the preferred return) but *gets to keep much (if not all) of the income* produced by the partnership. Only the preferred interest is included in the estate (plus cumulative payments on the preferred interest that have not been consumed). *See Estate of Boykin v. Commissioner*, 53 T.C. Memo 297 (1987) (decedent gave voting common stock and retained nonvoting preferred stock; IRS argued that the gifted voting stock was included in the gross estate under §2036(a)(1) because the decedent retained "nearly all the income from the transferred property"; court disagreed because the "only rights decedent retained were those accorded to the … nonvoting shares he retained, which were separate and distinct rights from the rights enjoyed by the voting shares that he transferred"). *See also Hutchens Non-Marital Trust v. Commissioner*, 66 T.C. Memo 1993-600 (1993) (interest that the decedent held in his family-owned corporation prior to recapitalization was not includible in his gross estate under §2036 because the decedent received adequate consideration for the pre-recapitalization stock, the decedent retained no interest in stock surrendered in the recapitalization, and the decedent's post-recapitalization control and dividend rights came from new and different forms of preferred stock that he received in the recapitalization). *But see Liljestrand v. Commissioner,* T.C. Memo. 2011-259 (all assets contributed to partnership were included in donor's gross estate under §2036 even though 14.8% of partnership interests had been given to trusts for children more than three years before his death; part of the court's reasoning as to the implied agreement of retained enjoyment under §2036 was that receiving guaranteed payments that represented the estimated partnership income reflects such an implied agreement).

b. **Brief Overview of Chapter 14.**

(1) **History and General Purpose.** Chapter 14 was adopted in 1990. It consists of special valuation rules designed to ignore discretionary rights or restrictions that were ignored in real life and that increased or depressed values artificially and were viewed as abusive.

Sections 2701, 2702, and 2704(a) apply a "deemed gift" approach. Section 2703 and 2704(b) apply a "disregard of provisions" approach.

Section 2701 and 2702 apply only for gift tax purposes. Sections 2703 and 2704 apply for gift and estate tax purposes.

(a) **Section 2701.** This section addresses entities with multiple classes of equity interests. A "senior interest" has a preferential right to payments or other rights (which were often discretionary) and the "junior" common interest represents the remaining value of the entity. (An example of such a "senior" preferred interest is preferred stock that receives dividends – which may be discretionary and/or non-cumulative - and that has a right to receive the par value of the stock when the preferred stock is redeemed.) The section applies if the senior generation (say, the "parent") retains the senior preferred interest while transferring the common interest to lower generations. The IRS thought that in many situations the senior interest retained by the parent was given a very high value, leaving the common interest a low value (say, only 10% of the entity), but the discretionary payments or rights ended up not actually being made or exercised (i.e., dividends on preferred stock or preferential payments on a partnership preferred interests were not actually paid), which had the effect of shifting substantial value of the entity to the transferred common interest. Section 2701 assigns a value of zero to certain rights or powers of the senior preferred interest and uses a "subtraction method" to determine the deemed value of a transferred common interest.

(b) **Section 2702.** Section 2702 applies valuation rules for transfers of interests in trust for "family" members (generally the transferor's spouse, descendants or siblings of the transferor) with an interest being retained by an "applicable family member" (generally, the transferor, his or her spouse, or ancestors of the transferor). Unless the retained interest is a "qualified interest" (i.e., has mandatory fixed payments or a fixed percentage of the trust value payable at least annually), it is valued at zero (so the amount of the gift is the ***entire*** value transferred to the trust). Classic exceptions recognized in the §2702 regulations are GRATs and qualified personal residence trusts.

(c) **Section 2703.** Section 2703 provides that certain rights and restrictions will be disregarded for estate or gift tax purposes in valuing assets. The application was originally intended for buy-sell agreements, but §2703 has been applied to other contractual rights. The IRS has tried, with limited success, to apply it to contributions to a family limited partnership or LLC. A right to acquire or use property for less than fair market value or a restriction on the right to sell or use property is disregarded (under §2703(a)) unless a safe harbor (under §2703(b)) is met. The safe harbor is a three part test: (i) a bona fide business arrangement, (ii) that is not a device to transfer assets to members of the family for less than full consideration, and (iii) that has terms comparable to similar arrangements entered into by persons in an arms' length transaction.

Planning Tip. Taxpayers have had a hard time establishing that they have satisfied the safe harbor test. Contractual restrictions still apply; they just are not given effect for transfer tax purposes. For example, a decedent's estate may still have to sell its stock at a low price set in the buy-sell agreement, but if it is not recognized for estate tax purposes, the estate tax value of the stock may be considerably higher. The estate tax conceivably could even exceed the amount the estate actually receives for the stock.

For discussions of §2703 and the §2703(b) safe harbor, see Item 29.f(4) of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and Items 16.b(4)(f) and 18.c(1)(a) of Estate Planning Current Developments and Hot Topics for 2022 (December

2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

(d) **Section 2704.** Section 2704(a) is a "deemed gift provision" that generally treats disappearing voting or liquidation rights as a taxable transfer for gift or estate tax purposes. (For example, in *Harrison v. Commissioner* (1987), a partner's right to withdraw from the partnership lapsed at the partner's death, resulting in a discount in the estate tax value of the interest.)

Planning Tip: If the planner is concerned that a *Powell* argument could be made regarding a parent's right as a limited partner or member to act in conjunction others to dissolve a partnership or LLC, do not just restructure the entity to remove the parent's right to vote or that might be treated as an immediate gift under §2704(a).

Section 2704(b) is a "disregarding provision" that ignores restrictions on the ability to dissolve a partnership or corporation when such dissolution right would otherwise be available under state law if there is a transfer of an interest in the entity to a member of the family and if the transferor and members of the family control the entity.

c. **Section 2701.** Section 2701 is a complex section with many detailed definitions, various exceptions, and a rather complicated approach for determining the deemed value of a transferred common interest. The following description of §2701 is merely a general overview of the very detailed provisions in §2701.

(1) **Triggering Events.** Section 2701 applies:

- if a senior generation family member (say, a parent) makes a transfer (very broadly defined)
- to a "member of the family" (defined generally to include the transferor's spouse or descendants or their spouses)
- while the transferor or some other senior family member (an "applicable family member," generally the transferor or the transferor's spouse or ancestors) retains an "applicable retained interest" defined as
    - a distribution right (i.e., a right to receive distributions with respect to an equity interest) IF the transferor and applicable family members (after applying attribution rules) CONTROL the entity (defined for a partnership as holding at least 50% of the capital or profits or any equity interest "as a general partner" ["as" a general partner may be distinguished from merely owning an interest "in" a general partner, see PLR 9639054 (§2701 did not apply where family owned 37% interest of the corporation that was the 100% GP)] and for a corporation as holding at least 50% of the total voting power or total fair market value of the equity interests), OR
    - an "extraordinary payment right" (defined as a put, call, right to compel liquidation, and other rights the exercise or non-exercise of which affect the value of the transferred interest).

(2) **Exceptions.** Section 2701 does not apply, though, (1) if the "applicable retained interest" retained by the senior generation or the transferred common interest have readily available market quotations on an established securities market, or (2) if the retained and transferred interests are of the same class (except for non-lapsing differences in voting rights) or proportionally the same. §2701(a)(1) (last sentence), §2701(a)(2).

Also, recognize that the triggering rule, by its terms, does not apply with respect to a retained distribution right if applicable family members do not control the entity and does not apply if the parent retains the "junior" common interest while transferring the senior preferred interest to the younger generation.

Various interests are not valued at zero under §2701 including (1) mandatory payment rights at a specific time (for example, a mandatory redemption at a certain date and certain value), (2) liquidation participation rights (a right to participate in a liquidating distribution even though there is no right to compel liquidation), (3) guaranteed payment rights under §707(c) of the partnership tax rules, or (4) non-lapsing conversion rights (right to convert into a fixed number or percentage of shares of the same class as the transferred common interest).

(3) **General Valuation Effect.** The applicable retained interest (i.e., the distribution right if the control requirement is met or the extraordinary payment right) is given a value of zero under a "subtraction method" of valuation UNLESS

- The distribution right is a "qualified payment right" (meaning a cumulative payment, payable at least annually, at a fixed rate (or if the donor makes an election to treat it as a qualified payment right), or
- The extraordinary payment right must be exercised at a specific time and for a specific amount and an extraordinary payment right does not include any nonlapsing conversion rights.

If the senior preferred interest is §2701-compliant (i.e., it has fixed cumulative preferred payment right),the preferred interest is not valued at zero but must be valued under traditional valuation principles. The goal would be to value the preferred interest at "par" or liquidation value. The valuation analysis under Rev. Rul. 83-120 starts with comparing the yield to high grade preferred interests in the same or a related industry, and then making adjustments because it is in a private partnership. Factors include the yield (as compared to risk-adjusted market comparables), coverage of the coupon (the ability of the entity to make the annual payments; a factor is how much of the equity interests in the entity is represented by the preferred interest), voting rights, and marketability issues.

(4) **Subtraction Method.** The subtraction method is described and illustrated with the following example (which is a rather traditional basic freeze transaction with a partnership). The subtraction method is discussed in great detail in Reg. §25.2701-3(b).

Example: Assume parent contributes $100 million to a partnership in return for a 50% voting preferred interest and a 50% nonvoting common interest. The preferred interest is not a qualified payment right (for example it may not have annual payments or cumulative rights to payments), but it has a liquidation participation right worth 50% of its value. Parent gives to G2 all of the common interest. A 35% valuation discount applies to the common interest under general valuation rules.

(a) **Step 1.** Determine the FMV of all family held equity interests immediately after the transfer, assuming the interests are held by one individual and using a consistent set of assumptions. ***Example: $100 million***

(b) **Step 2.** Subtract the value of the senior equity interest (i.e. the retained preferred interest, using the special valuation rules in §2701 described above).

Example: Distribution right – 0 (because not a qualified payment right)

Liquidation participation right (50% of the $50M for the preferred, or $25M)

So, $100M - $25M = $75M

(c) **Step 3.** Allocate the remaining value among the transferred interest and other junior interests (i.e., among the common interests).

Example: $75 million (because all common was transferred to G2; if only 10% of common had been transferred to G2, this would be 10% of the remaining value, or $7.5M)

(d) **Step 4.** Determine the taxable gift value of the transferred common interest (the amount in Step 3 is reduced by adjustments for minority discounts, transfers with a retained interest, or consideration received by the transferor). In the traditional situation, as described in the example, Step 4 reduces the value resulting from Step 3 by the excess of the value of the common, assuming control, but otherwise ignoring §2701 over the value of the common under traditional valuation principles.

Example: Subtract valuation discounts (35% x $75 M = $17.5M)

Result: $75M (from Step 3) - $17.5M = $57.5M

(5) **Special Rules: Minimum Value of Junior Interests; "Lower of" Rule.** Any transfer of a junior interest will be valued as if all junior interests had a value of at least 10% of the total value of all equity interests. §2701(a)(4).

If the transferor has retained both a qualified payment right and an extraordinary payment right, the gift is determined based on the lower value of the qualified payment right and the extraordinary payment right being ascribed to parent's preferred interest in applying the subtraction method. Reg. §25.2701-2(a)(3).

(6) **Result May Not Be Draconian.** Because values associated with liquidation participation rights or non-lapsing conversion rights can be given value, even if §2701 applies, and because value can be ascribed to any junior common interests retained by the senior family member, a significant value may still be ascribed to the grantor's retained interest, thus lowering the gift. Contrast that with §2702, which results in the entire transfer to the trust being treated as a gift if the retained interest is not a "qualified interest."

(7) **Red Flag Situations Suggesting That §2701 May Apply.** Red flag situations include the existence of: differing equity classes; a preferred interest; the parent retaining put, call, or conversion rights; recapitalizations; SPACs; carried interests; or profits interests.

d. **Carried Interests: Hedge Fund and Private Equity/Venture Capital Fund Structures.** Understanding the fund structures of entities with "carried interests" is essential to understanding the concept of the carried interest.

(1) **Hedge Funds.** The typical hedge fund arrangement involves outside investors and the fund principals. Outside investors own limited partnership (LP) interests. The fund principals typically own LP interests as well as the general partner (GP) interest. Fund profits are typically allocated 20% to the GP (the "carried interest"), sometimes subject to a "high water mark," and the residual 80% (or more) to the LPs. In addition, a management fee (typically 2% of assets under management) is also paid to the fund principals. The GP and the management company to which the management fee is paid are typically in separate entities owned by the principals. (The management fees for services are ordinary income and the carried interest payments are capital gain, so it is helpful to keep those payments totally separated, and having them separated can be helpful for state income tax purposes.)

Investors usually have the right to redeem at certain times and upon certain notice (for example, quarterly on 45 days' notice). Principals with LP interests in the hedge fund generally do not pay carry and/or management fees with respect to their LP interests.

(2) **Private Equity/Venture Capital Funds.** Private equity (PE) and venture capital (VC) funds have a similar structure. Investors are LPs and fund principals can have LP interests but also have GP interests. A carried interest (historically 20% of profits) is paid to the GP and the residual 80% is paid to the investors, with a separate management fee (traditionally 2%) of assets under management being paid to principals (typically to a separate management company). Principals with LP interests generally do not pay any carry and/or management fees with respect to their LP interests.

A difference from the hedge fund structure is that any payments are made pursuant to a waterfall. First, capital is returned to the investors, followed by the GP. Next, a preferred return

(typically 8%) is paid to the investors, followed by the GP. Last, 80% of remaining profits are paid to investors and 20% are paid to the GP. Another difference is that investors typically cannot withdraw; proceeds of investments are either paid all at once at the end of the fund or as individual investments are liquidated.

(3) **Favored Vehicles for Transfer Planning.** Carried interests are favored targets for transfer planning because they may have a relatively low value at the formation of the entity (because relatively little capital is contributed for the GP interest) and therefore very high appreciation (and cash flow) potential. However, it is conceivable that §2701 applies, treating the carry as a junior "common interest" and the LP interest as the senior preferred interest. Based on the legislative history of §2701, the Congressional intent does not seem to apply §2701 to carried interests, but the statutory language is overly broad and draconian consequences would result if §2701 is ultimately determined to apply. Common ways that are considered for planning with carried interests while avoiding §2701 are summarized.

e. **Carried Interest Planning.**

(1) **Vertical Slice Planning.** If the fund principal transfers a proportionate share of all his or her interests in the fund (capital invested in the GP, profits interests held by the GP (the carried interest), capital invested as a limited partner, and in some circumstances possibly interests in the management company, though some planners think that rights to a management fee are distinguishable from an equity interest and therefore would not have to be included), the "proportional share" exception to §2701 (similar to the same class exception) should apply. Reg. §25.2701-1(c)(4) ("proportional reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer"). The problem with that approach is that the principal may want to transfer a large percentage of the rights to the carried interest (low current value but high appreciation potential). Doing so would require also transferring that same high percentage of the principal's capital interests (as LP and as GP), with a much higher current value. (That could result in a gift of tens, if not hundreds, of millions of dollars in value.) The result is that the principal may be advised to transfer a considerably smaller percentage of the carried interest so that a proportional LP interest can also be transferred.

(2) **Holding Company to Facilitate Vertical Slice Transfer.** When the fund is created, the principal's LP and GP interests may initially be owned by a separate holding company (typically an LLC). A transfer of some percentage interest in the holding company would then be a proportional transfer of all the principal's equity interests in the fund. That can facilitate making the proportional transfer and being able to maintain proportionality in the future (for example, as capital calls are required). Having the holding company does not result in a greater value shift but is an administrative convenience (which may be significant).

Be mindful of §2036 concerns with that holding company if the principal has control over distributions from the holding company or the ability to vote on dissolution of the holding company. How does that work if the principal is the initial owner of all interests in the holding company at the outset? Perhaps the LLC would be managed by a non-member and the principal would just be an "investment adviser."

(3) **Compliant Preferred Partnership.** The fund principal's GP and LP interests may be owned by an LLC that is itself a §2701 compliant preferred partnership (with a fixed cumulative preferred interest). The principal might originally own the preferred interest and common interest, and later transfer some or all the common interest to descendants. That does not mimic a transfer of the carried interest and nothing else, but it is a way to transfer some of the upside growth potential of the carried interest.

(4) **Transfer to Trust for Extended Family Other Than Descendants.** The carried interest might be transferred to a trust for family members who are not "members of the family" (as defined in §2701(e)(1)). Beneficiaries of the trust could include parents, siblings, nieces and nephews, and cousins. Because there is not a transfer to a member of the family, §2701 would not apply. The

fund principal, who may be mega-wealthy compared to the rest of his or her family, may want to share some of the largesse with extended family members. A regulation says that an exception to §2701 is a transfer that results from the exercise of a non-gift power of appointment, so the trust might give someone a limited power of appointment to appoint assets to others (including the principal's spouse or descendants).

(5) **Upstream Trust Transfer.** The recipient trust to which the carried interest is transferred might be an "upstream trust" in which a parent or grandparent with a modest estate has a formula general power of appointment to provide benefits for the beneficiary but also to achieve a basis adjustment at the beneficiary's death of as much as possible without generating estate tax for the beneficiary. The beneficiary could also have a limited power of appointment over assets not subject to the formula general power of appointment to appoint assets back to the principal's descendants. See Item 9.d(7) above regarding upstream trust planning.

(6) **Hot Topics for Carried Interest Planning.**

(a) **Applicable Family Members Not in Control.** If no extraordinary payment rights exist and the only concern is if the LP interest is an applicable retained interest because it includes a "distribution right," that still does not make it an applicable retained interest triggering §2701 if the transferor and applicable family members (generally the transferor and ancestors) do not control the entity. Control is defined, for a partnership, as owning 50% of the capital or profits interest or owning any interest "as a general partner." "As" a general partner may be distinguished from merely owning an interest "in" a general partner, see PLR 9639054 (§2701 did not apply where family owned 37% interest of the corporation that was the 100% GP). How the control test is applied to an LLC (not addressed in the statute) is not clear. Perhaps the test would be the ability to cause a full or partial liquidation of the LLC.

(b) **Risk of Incomplete Gifts.** Hedge funds or PE/VC funds often have a vesting schedule for the carried interest. Otherwise, the principal might leave soon after creating the fund. Is a transfer of a nonvested interest in the GP (that receives the carried interest) a transfer that is an incomplete gift? Rev. Rul. 98-21 held that a transfer of compensatory nonvested stock options is an incomplete gift until the donee's right to exercise the option is no longer conditioned on the performance of service by the transferor. Does that same principle apply in the context of GP interests in a hedge fund or PE/VC fund? There are significant distinctions. A fund manager in the entity that is the fund's GP undoubtedly holds a substantial property interest. Even prior to vesting, he or she is entitled to allocations and distributions from the fund's GP and may be able to exercise certain voting and management rights under the entity's governing documents. To be conservative and minimize the risk, however, transfer vested interests first, followed by a transfer of unvested interests that will be the first in line to vest.

(c) **Ground Floor Investing by Trust; Capital Contribution or Gift of an Opportunity?** If a trust for descendants invests at the creation of the fund to receive some of the GP interest (which receives the carried interest), the IRS may ask what entitled the trust to receive such an interest in light of the fact it is not performing valuable services for the fund. The IRS may treat the transaction as a deemed issuance of the carried interest to the principal followed by a gift by the principal to the trust. Alternatively, did the principal merely facilitate the opportunity for the trust to invest but not actually transfer property? A conservative approach would be to treat the carried interest as a property right transferred by the principal.

An income tax issue is whether the receipt of the carried interest by the trust is subject to income tax on receipt of the interest. Rev. Proc 93-27 and Rev. Proc. 2001-43 provide a safe harbor for the receipt of a profits interest by someone providing services, but the safe harbor does not apply when it is received by someone other than the service provider. Receipt of the carried interest by the trust may be subject to immediate income taxation.

(d) **Valuation of the Carried Interest.** For income tax purposes, a profits interest is valued based on its liquidation value. At inception of the fund, the profits interest may be valued at

zero; an immediate liquidation would yield nothing for the profits interest holder. But for gift tax purposes, the willing buyer-willing seller test is the appropriate valuation standard. Aside from the special valuation rules of §2701, the carried interest may have substantial value. For a fund manager without a track record, the value of a carried interest may be quite low. But that changes on Fund 5 when all the prior funds were very successful.

f. **Family Office Profits Interest Planning.**

(1) **Family Office Fund Structure.** A family office (FO) may manage an investment fund for the family. The fund would have family members and trusts as investors, and the fund would provide a profits interest to the family office to manage the investments of the fund partnership. A profits interest may be used to attempt to qualify as a *Lender*-type arrangement so that the payments would be deductible to the fund as business expenses.

(2) **Owner of the FO?** If junior family members (or trusts for them) own the FO, and if the profits interest is considered a junior equity interest, §2701 may be triggered. The risk is that in restructuring an investment entity (such as a limited partnership or LLC) the senior family member could potentially be deemed to have made a substantial taxable gift under §2701 subject to immediate gift tax, representing a portion of the value of the LP interests in the entity, upon the issuance of the profits interest to the junior family member.

A simple way to avoid that result is for senior family members to own the FO. Other potential owners could be (i) a purpose-type trust not held for the benefit of individual family members or (ii) FO employees. However, having some of those owners might thwart *Lender*-type income tax planning. Also, having employees as owners of the FO may result in the FO not qualifying for the FO exemption for SEC registration purposes.

If the profits interest will be owned by junior family members, an important issue is whether §2701 is triggered.

- Does parent, who holds LP interests in the investment fund, own a "distribution right"? Or is it merely a right to receive distributions *with respect to* an equity interest rather than an equity interest itself?
- Is the same class exception applicable?
- Section 2701 could be avoided if the profits interest held by the FO and the LP interest held by the senior family member are "proportionally" the same interest, thus qualifying for the proportional interest exception to §2701.
- If the FO has a senior preferred interest and the parent retains a subordinate junior interest, §2701 does not apply. Is the profits interest more analogous to a junior common interest or a senior preferred interest?

Even if §2701 applies, significant value may be attributed to the senior family member's interest under the subtraction method, which would minimize the impact of §2701.

- The value of a liquidation participation right depends on various factors. A liquidation participation right is given a higher value in shorter-term partnerships.
- Also, in applying the subtraction method, if the FO has a 10% profits interest, that may be analogous to a situation in which 10% of the common stock is given to younger family members. In Step Three of the subtraction method, 90% of the common value would be allocated to senior family members (and not treated as part of the ultimate gift value). However, CCA 201442053 ascribed no value to the parent's retained capital interest (which should have been a liquidation participation right). Richard Dees (Chicago, Illinois) has written that the CCA is incorrect, and he indicates that a settlement with the IRS in that case did ascribe value to the capital interest retained by the parent. The Step Three provisions are designed to allocate the value in the most reasonable way possible.

- Panelists indicated that in structuring FO structures, do not plan to have the profits interest owned 100% or primarily by junior family members.

18. Family Offices

The information in this item is based primarily on information from Kim Kamin (Chicago, Illinois).

a. **General Description.** A family office is a privately held company that handles investment and wealth management for one or more ultra-high net worth families. The term generally refers to a "single family office" (SFO). One way of doing that is as an embedded family office in a family operating business, run out of the proverbial corner of a family-run business and served by company employees. A family office can also operate as a "multi-family office" (MFO) when the office serves two or more families. In another alternative, referred to as a "virtual family office" (VFO), a family uses outside financial institutions or professionals to provide advice and services needed by the family rather than creating a formal family office infrastructure staffed by employees, with substantially lower cost than establishing an SFO. Another alternative is to create a private trust company.

General functions served by the family office can include (1) administrative functions, (2) investments/wealth management, and in some cases, (3) fiduciary functions.

A family office may evolve over time as the value and complexity of wealth and number of family members (or the number of families) being served increases. The sale of an operating business may dramatically change the role of a family office.

Approximately 3,000-7,000 single family offices operate in the U.S., and there are as many as 20,000 worldwide.

According to a survey by the Family Office Exchange, about 33% of family offices are LLCs, 20% are S corporations, 16% are C corporations, 14% are embedded family offices in an operating business, and 10% are private trust companies.

b. **Range of Services.**

(1) **Investments.** Developing investment policy, manager selection, performance reporting.

(2) **Wealth Transfer Planning.** Organizing goals, coordination with outside professionals regarding legal and tax strategies, trust administration.

(3) **Philanthropy.** Organizing objectives of various family members and individual giving programs, management of DAFs or family foundation.

(4) **Integrated Financial Services.** Cash flow and financial planning, overseeing bank financing issues.

(5) **Information Management.** Document management, consolidated reporting.

(6) **Family Continuity/Education.** Family governance, family meetings and education.

(7) **Tax Review and Compliance.** Coordination with return preparers, estimated tax payments, year-end planning.

(8) **Risk Management.** Coordinating insurance, cybersecurity.

(9) **Lifestyle Enhancements.** Bill paying, concierge services, travel management, healthcare.

c. **Owner and Control of Family Office.** Possibilities for ownership include the founder, family members, or a long-term family trust. Consider the ability of owners to add additional capital when needed for the family office.

Control may follow the ownership, or control may be organized among family lines. Outside directors or advisory committees may be appropriate as the family office grows. Governance structures may include a family council and/or family assembly elements.

d. **SEC Family Office Exemption.** Generally, the goal is that the family office not be required to register with the SEC as an investment adviser. The Investment Advisers Act of 1940 has a broad registration exemption for "small advisers" with 14 or fewer clients in any rolling 12-month period. The exemption was eliminated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"). Under Dodd-Frank, most investment advisers are required to register, but it includes a Family Office Exemption for family offices owned exclusively by "family clients," with a broad definition of family that includes stepchildren, former spouses, most trusts and entities, family foundations and other family nonprofits, estates of deceased family members, and wholly owned companies. Control must be limited to family members and their entities.

e. **Staffing.** The family office may be staffed by family members or outside professionals. Sometimes CPAs or estate planning attorneys are selected to run family offices. One of the biggest concerns of family offices is finding and retaining talent. When someone who has handled these functions for the family leaves the family office, that is incredibly disruptive.

f. **Fee Structures.** The family office may be paid for its services under a variety of options including fixed fees, hourly fees, a percentage of resources used, a percentage of assets under management (with or without a performance component), or a profits interest. An important secondary issue is how the fees will be allocated among family members or family lines.

g. **Deductibility of Family Office Expenses.** When the family had an operating business, expenses could be deducted as business expenses. The expenses of providing family services, however, are not deductible. A profits interest structure by a C corporation (or LLC taxed as a C corporation) may be a solution in a very specific situation that fits the profits interest.

   Higgins v. Commissioner, 312 U.S. 212 (1941) held that managing one's own investments is not a trade or business. The 2017 Tax Cuts and Jobs Act suspended through 2025 the individual deductibility of many previously deductible family office expenses. Even before that, various factors limited the availability of deductions under §212 of individual expenses, and the family in *Lender Mgmt., LLC v. Commissioner*, T.C. Memo. 2017-246, organized its family office using a profits interest structure to treat the expenses as deductible business expenses under §162. The court recognized that providing investment management for others is a trade or business. A bona fide investment management trade or business does not lose its status as a trade or business merely because taxpayers invest their own funds alongside those managed for others. *Hellman v. Commissioner* settled after the court refused to grant summary judgment recognizing a profits interest structure as representing deductible trade or business expenses. The profits interest was allocated proportionately among relevant family members; accordingly, they essentially received the same investment return as if they were fractional equity investors. Also, investments were managed for fewer family members who were close both geographically and personally.

19. Foreign Trusts

This information is based on information from Michelle Graham (San Diego, California).

a. **Identifying Foreign Trusts.** Civil law countries (most of Europe, Asia, South America, and Central America and some of Africa) often do not recognize trusts. The planner must determine if an entity is taxed as if it is a trust, a corporation, or a partnership. That is significant in order to be able to apply the correct tax treatment and to determine which, if any, information reporting obligations may apply (for example, substantial penalties may be imposed for failure to file timely and correct Forms 3520 and 3520-A).

   Treasury regulations define a trust as an arrangement created by will or by an inter vivos declaration in which a trustee takes title to property for the purpose of protecting or conserving it for beneficiaries who cannot share in the discharge of this responsibility (and therefore are not "associates" in a joint enterprise for the conduct of business for profit). Reg. §301.7701-4(a).

   A "fideicomiso" (which translated means "trust") is often used in Mexico. They are often treated as trusts, but not always – not if created as business entities. In addition, a fideicomiso is often used in Mexico to merely hold title to property to avoid foreign ownership restrictions (foreigners cannot own

property within 100 km of the Mexico border or 50 km of the coast); if that is the case, it is treated as a nominee rather than as a trust for tax purposes. Rev. Rul. 2013-14, 2013-26 I.R.B. 1267.

Stiftungs and Foundations are common in some civil law countries (namely Liechtenstein, Austria, Switzerland, Germany, and Panama). They look like corporations (with articles, officers, and directors), but they may be administered by officers in a fiduciary capacity to preserve property for the founder or the founder's family and may therefore be treated as trusts. *Estate of O.T. Swan v. Commissioner*, 24 T.C. 829 (1955), *aff'd*, 247 F.2d 144 (2d Calif. 1957); IRS Advice Memorandum 2009-012 (subject to the facts and circumstances of each situation, Liechtenstein Stiftungs are generally properly treated as trusts for U.S. tax purposes).

Usufructs are similar to life estates (the "bare owner" holds legal ownership and the usufructuary interest holder has the right to use the property and receive its income for a specified term and has the duty to maintain the property). Because typically there is no separate fiduciary, usufructs are generally treated as life estates rather than as trusts.

After determining that an arrangement is treated as a trust, a determination must be made whether it is a foreign or domestic trust and whether it is a grantor or nongrantor trust (the tax treatment is significantly different depending on those classifications).

b. **Foreign or Domestic Trust?** A trust is treated as a domestic trust under §7701(a)(30)(E) if two tests are met: (1) Court Test (a court in the U.S. [not including U.S. territories or possessions] is able to exercise primary supervision over the trust administration); and (2) Control Test (one or more U.S. persons have the authority to control all "substantial decisions" of the trust).

The Court Test is satisfied if (a) the trust instrument does not direct that it be administered outside the U.S., (b) the trust is in fact administered exclusively in the U.S., and (c) the trust is not subject to an automatic migration provision (for example, that the trust must migrate to a foreign country if the beneficiary is sued), with a few exceptions. Reg. §301.7701-7(c)(1). The regulations have four "bright-line" rules, describing situations under any of which the Court Test is satisfied:

(a) the trust is registered in the U.S. pursuant to a statute similar to Uniform Probate Code provisions for trust registration (currently available in Alaska, Colorado, Hawaii, Idaho, and Nebraska);

(b) the trust is created by a will probated in the U.S.;

(c) steps are taken to cause the administration to be subject to court supervision in the U.S.; or

(d) both a U.S. court and a foreign court are able to exercise primary supervision over administration of the trust. Reg. §301.7701-7(c)(4).

The Control Test is satisfied if one or more U.S. persons (U.S. citizens or residents) have the authority to control all "substantial decisions," not including ministerial functions (such as bookkeeping, collection or rents, and execution of investment decisions). Reg. §301.7701-7(d)(1)(ii). In making that determination, consider all persons who can make substantial decisions, not just the trust fiduciaries. If a non-U.S. person controls or can veto a substantial decision, the Control Test is not met. Reg. §301.7701-7(d)(1)(iii). "Substantial decisions" include but are not limited to (a) whether and when to distribute income or corpus, (b) the amount of any distributions, (c) the selection of a beneficiary, (d) whether a receipt is allocable to income or principal, (e) whether to terminate the trust, (f) whether to compromise, arbitrate, or abandon claims of the trust, (g) whether to sue on behalf of the trust or to defend suits against the trust, (h) whether to remove, add, or replace a trustee, (i) whether to appoint a successor trustee (even if not combined with a removal power) unless the appointment must be made in a manner that would not change the trust's residency from foreign to domestic or vice versa, and (j) investment decisions (including if a U.S. person can terminate an investment advisor's power to make investment decisions at will). Reg. §301.7701-7(d)(1)(ii)(A)-(J).

An inadvertent change in the power to make a substantial decision that would cause the trust residency to change may be corrected within 12 months from the date of the change by changing

persons who control the substantial decision or changing the residence of such persons. Reg. §301.7701-7(d)(2).

c. **Grantor or Nongrantor Trust?** The first step is determining the grantor. Foreign trusts sometime name a third party (such as the attorney who drafted the trust) as the grantor, but the true grantor who makes a direct or indirect *gratuitous* transfer of property to the trust is treated as the grantor for tax purposes. Reg. §1.671-2(e)(1). Also, a beneficiary who holds and exercises a §678 power is treated as a grantor. Reg. §1.671-2(e)(6), Ex. 4. If a trust makes a gratuitous transfer to another trust, the grantor of the transferor trust generally is treated as the grantor of the recipient trust, but if assets are transferred to another trust by way of exercise of a general power of appointment, the power holder is treated as the grantor of the transferee trust. Reg. §1.671-2(e)(5).

   If the grantor is a U.S. person, it is generally hard to avoid having the trust treated as a grantor trust. A trust is a foreign grantor trust when established by a U.S. person and (a) the grantor is treated as the owner of the trust under §671-678, or (b) the trust has or may have U.S. beneficiaries (which decision is made annually). §679. The trust is treated as having a U.S. beneficiary unless no income or principal may be paid to or accumulated for a U.S. person and none of the trust can be paid to a U.S. person if the trust terminates during the year. Reg. §1.679-2(a)(2). That determination is made without regard to whether a U.S. person's interest in trust income or corpus is contingent on a future event. Effective after March 18, 2010, if a U.S. person borrows or uses trust property without paying a market rate of interest or rent, that person is treated as a U.S. beneficiary. (If the goal is to avoid treating a foreign trust as a grantor trust, the trust agreement should specifically prohibit distributions to or accumulations for a U.S. person.)

   If the foreign trust is created by a non-U.S. person, it is much more difficult to cause the trust to be a grantor trust. It will be a foreign grantor trust only if (a) it is revocable by the grantor, either alone or with the consent of a related or subordinate party, or (b) distributions of income or corpus may be made only to the grantor or grantor's spouse during the grantor's lifetime.

   A five-year rule applies; if a non-U.S. person creates a foreign trust and becomes a U.S. person within five years of transferring property to the trust, directly or indirectly, the person will be treated as having transferred an amount equal to the portion of the trust attributable to the original property transfer (including undistributed accumulated income of the trust) on the date that such person became a U,S, person. To that extent the trust will become a grantor trust if the trust has a U.S. beneficiary when the grantor becomes a U.S. citizen or resident. §679(a)(4). (This prevents pre-immigration planning by setting up nongrantor trusts before moving to the U.S.)

   A foreign nongrantor trust is a foreign trust that is not a grantor trust under the rules of the preceding paragraphs.

d. **Taxation of Foreign Grantor Trusts.** Worldwide income of the trust is taxed to the U.S. grantor; all income, deductions and credits are included in the grantor's income. A non-U.S. grantor of a foreign grantor trust is taxed on income of the trust as if it did not exist, meaning that the non-U.S. grantor will be taxed on U.S. source income and income effectively connected to the U.S.

   Transfers of property from U.S. persons to foreign grantor trusts are *not* treated as taxable exchanges under §684 (in contrast to the recognition treatment applied to the transfer of property by U.S. persons to nongrantor trusts). §684(b).

   At the death of a U.S. grantor, the appreciation in the foreign grantor trust is subject to income tax under §684 (gain but not loss is recognized), but gain recognition under §684 will not apply if the basis of the property in the hands of the transferee is stepped up under §1014(a) (for example, if the value of the trust property is included in the U.S. grantor's gross estate for estate tax purposes).

   At the death of a non-U.S. grantor, the grantor will be subject to U.S. estate tax on trust assets with a U.S. situs. Estate tax cannot be avoided by simply converting U.S. assets to non-U.S. assets prior to the non-U.S. grantor's death because of special provisions in §2104(b). (Section 2104(b) may be avoided by having the non-U.S. grantor revoke the original trust that held U.S. assets and fund a new

trust with non-U.S. assets; the non-U.S. assets in the trust would then not be subject to U.S. estate tax at the grantor's death.)

e. **Taxation of Foreign Nongrantor Trust.**

(1) **Outbound Migration.** Section 684 provides that any transfer of property by a U.S. person to a foreign nongrantor trust will be treated as a taxable exchange, with several exceptions, one of which is if the transfer from the U.S. person is at the person's death, the trust assets are in the person's estate, and the assets receive a basis adjustment under §1014(a). Reg. §1.684-2(e)(2), Ex.2; §1.684-3(c), §1.684-3(e). In addition, if a domestic trust becomes a foreign trust, that is treated as a taxable transfer by the domestic trust of all property to a foreign trust before the change of residence status (unless one of the §684 exceptions applies); gain but not loss will be triggered. §684(c).

(2) **Taxation of U.S. Source Income and Effectively Connected Income.** A foreign nongrantor trust is treated as a nonresident individual not present in the U.S. It is taxed on (a) U.S. source income and (b) gross income that is effectively connected with the conduct of a trade or business in the U.S. The two categories of income are taxed differently regarding their deductions, tax rates, and withholding. U.S. source income is subject to withholding at a flat 30% rate or a reduced treaty rate (and no tax return is required if all taxes are properly withheld) whereas effectively connected income is taxed at the graduated rates that apply to U.S. persons (and must be reported on a tax return).

(3) **Distributions of Current Income.** U.S. beneficiaries of nongrantor trusts (whether U.S. or foreign) are taxable on distributions of current income (reflecting proportionately the character of the trust's income), up to the amount of the trust's DNI, and the trust is entitled to a distribution deduction. The DNI of a foreign nongrantor trust includes all capital gains, §643(a)(6)(c), (whereas the DNI of domestic trusts generally does not include capital gains, §643(a)(3)).

(4) **Throwback Tax on Distributions of Accumulated Income to U.S. Beneficiaries.** A dramatic difference in the treatment of foreign vs. domestic nongrantor trusts is that throwback rules apply to the distribution of accumulated income to U.S. beneficiaries from foreign nongrantor trusts (§665), with a two-fold effect. First, the accumulated income that is distributed does not retain its character, but is taxed entirely as ordinary income (e.g., capital gain from prior years is taxed as ordinary income). Second, some portion of the distribution is "thrown back" to prior years and is treated as having been taxable in those prior years (subject to the recipient's highest marginal income tax rate in each respective year), §667, and the U.S. beneficiary is subject to an interest charge on tax attributable to any income thrown back to each respective prior year, §678. Accordingly, an accumulation distribution to a U.S. beneficiary can result in a substantial amount of tax and interest. To avoid this sometimes Draconian tax and penalty-like interest charge, foreign nongrantor trusts generally attempt to avoid accumulating income for U.S. beneficiaries.

(5) **Loans from Foreign Nongrantor Trusts.** To prevent U.S. beneficiaries from avoiding the harsh throwback tax by simply taking loans from foreign trusts rather than receiving distributions, §643(i) was amended in 2010 so that a loan or use of property by a U.S. person who is a grantor or beneficiary (or someone related to them) will be treated as a distribution to the grantor or to the beneficiary. An exception applies for "qualified obligations" that meet strict tests under IRS Notice 97-34. A "qualified obligation" must meet several requirements: (a) it must be in writing, (b) it must be limited to a term of not more than five years and must actually be paid during that term, (c) the yield to maturity must be not less than 100% but cannot exceed 130% of the AFR for the day the obligation is issued, (d) the U.S. beneficiary must generally agree to a three-year extension on the period of assessment of income or transfer tax and must report payments on Form 3520, and (e) the U.S. beneficiary must report the status of the obligation on From 3520 for every year the loan is outstanding.

f. **Reporting Requirements.** Very detailed reporting requirements apply for foreign trusts, beginning importantly with a requirement that a U.S. person who receives a distribution, directly or indirectly, from a foreign trust after August 20, 1996, must report the distribution on Form 3520. §6048(c).

Clients with foreign trusts should make sure that their accountants are very familiar with all the many detailed reporting requirements.

20. Cybersecurity, Privacy and Ethics for the Estate Planner

The following are a few observations from a panel discussion by Jeff Chadwick, R. Kris Coleman (formerly with the CIA and FBI), and Elizabeth Vandensteeg.

a. **Significance.** The financial costs of dealing with a data "breach" are substantial. IBM Security publishes an annual study of the costs of data breaches, and the average global cost for 2023 for a data breach was $4.45 million (worldwide) and $9.48 million (in the U.S.). The biggest causes of data breaches were phishing (16%) and stolen or compromised credentials (15%). On average, the time to discover that a breach had occurred was 240 days. Only about a third of breaches were discovered by the organization's own security team. Forty percent were discovered by a benign third party (for example, someone notifying the organization they had received a strange email). In 27% of cases, the bad actor notified the company (typically with a ransomware request).

   A data breach can also result in huge reputational risk for the organization.

b. **Information at Risk.** Information at risk to be protected includes intellectual property (business property, client lists, geolocation of assets, digital assets (including cryptocurrency), employee information), physical assets (facilities, human life, financial assets such as cash or other commodities), and intangible assets (the corporate brand or the family legacy).

c. **Attackers.** The big threats are typically financially motivated, often from criminal enterprises or national states. Organized crime groups in Eastern Europe are responsible for many of the attacks. Attacks also come from national states (North Korea or Russia, for example; North Korea finances all its missile and WMD programs from stolen cryptocurrency).

d. **Defenses.** In general terms, defenses include physical safeguards (e.g., locked cabinets and storerooms, receptionists to screen visitors), technical safeguards (e.g., IT defenses, basic firewalls, regular password changes, multi-factor authentication), and (most important) administrative safeguards (e.g., adopting and implementing internal policies and practices, training of employees, identifying specific threats).

e. **Ethics.** Relevant ABA Model Rules of Professional Conduct are Rules 1.1 (Competence), 1.3 (Diligence), 1.6 (Confidentiality), 1.15 (Safekeeping of Property), 1.4 (Communications), and 5.1 (Responsibilities of a Partner or Supervisory Lawyer), and 5.3 (Responsibilities Regarding Nonlawyer Assistance).

   Rule 1.1, Comment 8 requires that attorneys keep abreast of "benefits and risks associated with relevant technology." Rule 1.6, Comment 18 requires attorneys to use reasonable efforts to prevent access to or disclosure of client information, with a list of factors for consideration. Rule 1.6, Comment 19 similarly requires reasonable precautions regarding the transmission of information, with a list of factors for consideration.

   ABA Opinion 477R addresses securing the communication of protected client information and explains considerations for best practices. ABA Opinion 483 discusses an attorney's ethical obligations after a data breach occurs.

f. **International Travel.** International travel creates a significantly increased cybersecurity risk. If one crosses a border, there is a significant likelihood that their digital devices and laptops will be searched, and any information on the devices can be taken. Especially if traveling to a country (such as China) that has a higher risk of economic espionage, extortion, or stealing of digital assets, take only a burner phone (rather than one's regular phone that has all sorts of data on it) and no laptop; just rely on a pen and paper.

g. **Passwords.** The length and complexity of passwords is very important. Passwords should have at least 16 characters with very random and complex digits. Password managers are highly recommended (and much safer than "a manilla folder" containing all passwords). The password for

the password manager should be especially long and complex; something that can be remembered with a special phrase and nothing anyone else could guess (birthdates, family names, etc.).

h. **Hotel Wi-Fi.** Do not use hotel Wi-Fi (especially while traveling overseas). Unless a trusted VPN is available, it is better to use the Hotspot on your telephone. The problem with local Wi-Fi is that you don't know "who is in the middle" reading every email message that is sent or received.

i. **Artificial Intelligence.** Do not put any important information in AI; the privacy of that information is given up without knowing how the information will be used or where it resides. The information becomes the property of someone else.

AI can have "hallucinations" – output that is not logical based on learning in the past and that is not accurate.

AI has greatly increased the risk of cyberattacks. Tens of thousands of attacks can be generated daily, hoping that a handful will result in breaches. For example, attackers can purchase 10,000 names and Social Security numbers on the Dark Web for about $0.39 each, hoping for just a few successful "hits."

AI is a balancing phenomenon. Some of the best cybersecurity defense comes from AI, but the "bad people" will always stay a step ahead.

j. **Text Messages.** Be very skeptical of SMS texting. Employees get hit daily. Be very skeptical of anything that comes by text.

21. Directed Trusts

The information in this item is based primarily on information from Michael Gordon (Wilmington, Delaware).

a. **What is a Directed Trust?** A traditional trustee is vested with three distinct responsibilities: (1) managing investments, (2) making distribution decisions, and (3) handling the trust administration (tax filings, record keeping, etc.). With a directed trust, one or more of those responsibilities is vested in someone other than the trustee. Many states now statutorily recognize the validity of directed trusts and protect the various fiduciaries involved when one of the other fiduciaries takes an action or fails to take an action that results in liability.

b. **Main Reasons Directed Trusts are Utilized.** Why would a client want to create a trust and not vest the trustee with traditional powers? Some of the most common reasons direction advisers are used include:

(1) **Corporate Trustee in Different Jurisdiction Than Trusted Investment Manager.** The client may create a trust in a particular jurisdiction to take advantage of that state's trust laws but already have a trusted investment manager. Sometimes the investment manager is not in the correct jurisdiction or does not have the ability to serve as a trustee. In this situation, a directed trust can be the perfect fit—a corporate trustee in the desired jurisdiction may be appointed while the trusted investment manager continues to manage the investments as an Investment Direction Adviser.

(2) **Closely-Held Business.** The client may be transferring an interest in a closely-held business to the trust. In this situation, the client typically does not want the corporate trustee involved in the management of the company as a traditional trustee. Most often, the corporate trustee would prefer not to be involved with the business either and would prefer to be directed on how to vote the stock, etc. by an Investment Direction Adviser.

(3) **Concentrated Investment Positions.** The client may be transferring a concentrated position to the trust and intend for the trust to continue to hold such position. A corporate trustee most likely will not feel comfortable holding a concentration long-term without diversifying if the trustee is responsible for managing investments.

(4) **Family Member to Direct Distributions.** The client may trust a corporate trustee to manage investments and properly handle the administration matters but feel that a corporate trustee will not be able to know the client's children and what their goals and needs are. In that situation, the client may wish to appoint another family member or family friend as a Distribution Adviser to direct the trustee when to make distributions.

(5) **Difficult Distribution Standards.** The client may wish to include guidelines regarding when distributions can or cannot be made that could make a corporate trustee uneasy. For example, the client may wish to prohibit distributions to descendants who are not "productive members of society" or may prohibit distributions when the beneficiary is dealing with substance abuse issues. In some situations, it can be better for an individual who intimately knows the beneficiary to serve as a Distribution Adviser, better knowing the intent of the grantor and the status of the beneficiary's lifestyle.

c. **Structuring Different Roles**. Some planners typically include direction adviser roles in all trust agreements as a standard practice, even if the client does not want or need a directed trust initially. If a need arises in the future, the necessary language is in the document, and a modification of the trust agreement will not be necessary. In the meantime, if any of the roles remain vacant, the trustee will possess the powers that would otherwise be held by the direction advisers (but not the Trust Protector role, as discussed further below). Mr. Gordon provided sample provisions for each of these roles.

(1) **Investment Direction Adviser/Special Holdings Adviser**. The most common type of directed trust is one where the trustee is directed regarding investment decisions. Some directed trusts have Investment Direction Advisers with responsibility for all investments held by the trust, and others have the more limited role of Special Holdings Adviser. A Special Holdings Adviser may be appointed to have responsibilities only with respect to a certain holding or class of assets, such as a concentrated position or closely-held business. Other investments not included in the definition of "Special Holdings" would be managed by the trustee. Another option for utilizing a Special Holdings Adviser is when the grantor wishes to serve as the Investment Direction Adviser but there needs to be another party in charge of difficult assets that could cause estate inclusion if the grantor has control over them, such as life insurance or stock of a controlled corporation. In that situation, there could be a Special Holdings Adviser with authority over the difficult assets only, and the Investment Direction Adviser could have authority over all other investments.

(2) **Distribution Adviser**. Another type of directed trust is one where the trustee is directed by a Distribution Adviser on whether and when distributions are to be made to beneficiaries. This may be particularly helpful with beneficiaries who have substance abuse issues or special needs.

(3) **Trust Protector**. Unlike Investment Direction Advisers and Distribution Advisers, Trust Protectors do not have standard powers. Some trust agreements arm the Trust Protector with the sole power to remove and replace a trustee. Other trust agreements grant the Trust Protector broad authority to do many different things. Mr. Gordon is in the latter camp and typically provides his Trust Protectors with the powers to remove and replace the trustee, to change situs and governing law, to amend the trust for limited purposes, to change the tax status from grantor to nongrantor, and to expand the class of permissible beneficiaries. This is the only role Mr. Gordon is comfortable with being served in a non-fiduciary capacity because these are non-traditional powers, some of which he feels are not capable of being exercised in a fiduciary capacity because they may not be in the best interest of the beneficiaries. This is also why these powers do not revert to the trustee in the event there is no Trust Protector serving—they are non-traditional powers that trustees should not hold.

(4) **Administrative Trustee**. The Administrative Trustee (or just "trustee") has all the duties and responsibilities that are not granted to the other Advisers. If a trust has an Investment Direction Adviser and a Distribution Adviser, the trustee will truly only hold administrative powers, such as keeping proper books and records, completing tax filings, sending statements, etc. The preferred structure for directed trusts is to have all decisions run through the trustee or Administrative

Trustee. The Investment Direction Adviser and the Distribution Adviser communicate all decisions to the trustee, and the trustee is the one who carries out all actions and communicates with the beneficiaries. This approach allows for the most cohesive administration of a trust.

22. Below-Market Loans From Trusts

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

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

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

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

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

(c) **"Tax Avoidance" Loans.** In a particular circumstance, an interest-free loan may not be a "tax avoidance loan" under §7872(c)(1)(D) because the beneficiary may have the imputed interest carried out to her as a DNI distribution, and the loan proceeds may be used for a purpose such that the interest would be deductible by the beneficiary and therefore offset the income, or the fiduciary may have a purpose for making the interest-free loan independent of tax consequences.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

a. **Synopsis and Basic Facts.** QTIP trusts, funded when the predeceased spouse died in 1992, were decanted in 2013 to trusts with a broadened testamentary power of appointment (that could be exercised by a signed written instrument taking effect at the surviving spouse's death) allowing the surviving spouse to appoint the assets to charity. The surviving spouse died in 2015 having appointed about $20 million to charities and her estate claimed an estate tax charitable deduction. The IRS took

the position that the decanting was not appropriate, that the assets did not properly pass to the charities, and that no estate tax charitable deduction was allowed.

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

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

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

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

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

b. **Observations.**

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

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

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

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

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

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

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

This conclusion seems incorrect; if the governing instrument is effectively modified under state law before the transfer to charity, subsequent transfers would seem to be made pursuant to the terms of the governing instrument in the absence of guidance under §642(c) that it looks only to the governing instrument as originally executed, without valid modifications. The case involved with the 2016 and 2017 CCAs was subsequently settled.

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

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

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

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

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

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

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

Shortly before trial (on the 30-days-before-trial deadline for offering valuation opinions) the IRS backed off substantially by offering their expert's appraisal that gave only a 10% (down from 100%) weighting to the asset value approach, reducing the alleged deficiency to $3 million (down from $26 million!). The IRS used one appraiser to appraise artwork owned by the corporation (at $13,250,000) and another to value the donated shares using an asset-based method (but weighting it at only 10%) and an income method (and that appraiser also used tax affecting under the income approach analysis).

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

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

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

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

The court analyzed the reports from the various experts. The court assigned "zero weight" to the IRS expert because it used an asset-based approach even though liquidation was "most unlikely" (without commenting on the fact the appraiser assigned merely a 10% weight to its asset-based approach and without noting that it actually *did* apply parts of that expert's analysis). Assigning a **zero weight to the asset-based approach** was very significant because of the dramatic difference between the ongoing concern value and the asset value of the business—reportedly **roughly $15 million vs. $147 million** (the total asset value as determined by the IRS's valuation expert). The court adopted the IRS's expert's 17.6% rate for applying the tax affecting analysis. The court found flaws in both of the taxpayers' experts reports as well but used one of the reports as "the truest value of the subject stock's prediscount fair market value" (but applying a different rate for the tax affecting analysis). The court adjusted the lack of control and marketability discounts, applying both a **20% lack of control discount** (used by one of the taxpayer's experts) and **lack of marketability discounts of 19%, 22% and 27%**, respectively, for the voting stock, the 15.57% blocks of nonvoting stock and the 23.36% blocks of nonvoting stock (marketability discounts used by the IRS's expert).

Even after adjustments are made for the differences in the lack of marketability discount and the adjustment to the rate used in the tax affecting analysis, the approximately $1,100 per share value in the report is much lower than the roughly $3,300 per share value used on the gift tax return, suggesting that the taxpayers may be entitled to a substantial gift tax refund. *Estate of Cecil v. Commissioner*, T.C. Memo. 2023-24 (February 28, 2023, Judge Ashford).

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

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

   (2) **Income Approach.** The income approach computes the present value of the estimated future cashflow, using an appropriate discount rate for that type of property and adds that to the present value of the residual value of the property.

   (3) **Asset-Based Approach.** This approach is generally the fair market value of the net assets (assets less liabilities). This approach is often not appropriate for ongoing businesses that will not be liquidated in the foreseeable future.

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

d. **Tax Affecting.** "Tax affecting" refers to the step in the valuation of a closely-held business that seeks to adjust for certain differences between passthrough entities and C corporations. The rationale for tax affecting was described very simply in *Cecil*: "Where, as here, the data used to value

an S corporation are largely based on the data from C corporations, proponents of tax affecting believe that the mismatch from pretax cashflows and after-tax discount rates must be adjusted through tax affecting to ascertain the fair market value of the S corporation." Typically, tax affecting is discussed in the context of S corporation valuations, but tax affecting can be applied in valuing other passthrough entities, i.e., partnerships. (*Estate of Jones* applied a tax affecting analysis in determining the valuation of an S corporation and a limited partnership.)

(1) **Analysis in *Cecil*.** Although the IRS's internal valuation guide had for years in discussing S corporation valuations referred to the need to adjust the net income for income taxes using corporate tax rates when using industry price to earnings ratios, the *Gross v. Commissioner* Tax Court case in 1999 concluded that tax affecting is not appropriate in that case; in fact, Judge Halpern pointed out that owners expect to save money by using S corporations and that savings should not be ignored. T.C. Memo. 1999-254, aff'd, 272 F.3d 333 (6th 2001). The *Cecil* court observed that the Tax Court has continued to reject tax affecting in valuing S corporations, citing various subsequent cases (*Estate of Gallagher*, *Dallas*, *Wall*, and *Estate of Giustina*)

The court discussed two more recent cases. *Estate of Jones* allowed tax affecting in part because the IRS's expert was largely silent about tax affecting other than to disagree with the way taxpayer's expert had applied it. However, *Estate of Jackson* rejected a tax affecting analysis based on an assumption that buyers would be C corporations. In *Jackson* the court was not persuaded that the buyers would necessarily be C corporations.

In light of that history, Judge Ashford seemed reluctant to adopt a tax affecting analysis. But the court concluded, and even the IRS's expert agreed, that tax affecting should be applied), and the circumstances of the case "require our application of tax affecting."

> Here, experts on both sides agree that tax affecting is necessary to value the subject stock. Messrs. Morrison [the IRS's expert] and Hawkins [one of the taxpayers' experts] also agree that the SEAM method is the appropriate method to employ in the setting at hand to account for tax affecting and that a factor of at least 17.6% applies here for that purpose. As we observed in *Estate of Jackson,* there is not a total bar against the use of tax affecting when the circumstances call for it. Now given that each side's experts (with the exception of Ms. Wolf [the IRS's art appraiser] who did not opine on this point) totally agree that tax affecting should be taken into account to value the subject stock, and experts on both sides agree on the specific method that we should employ to take that principle into account, we conclude that **the circumstances of these cases require our application of tax affecting.** While Messrs. Morrison and Hawkins do not agree on the specific rate that applies here to implement tax affecting (Mr. Hawkins determined the rate to be 24.6% while Mr. Morrison determined the rate to be 17.6%), we consider it appropriate on the basis of the record (and relying on Mr. Morrison's opinion in this regard) to set that rate at 17.6%. **We emphasize, however, that while we are applying tax affecting here, given the unique setting at hand, we are not necessarily holding that tax affecting is always, or even more often than not, a proper consideration for valuing an S corporation.** (emphasis added)

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

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

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

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

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

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

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

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

  The court observed, "That is not the setting here."
- Liquidation is most unlikely.
  - A hypothetical buyer would be unlikely to acquire enough shares to force liquidation, convince other shareholders to vote for liquidation, or wait until shareholders decide to liquidate.
  - The family members who own the company's shares all testified that they had no intention of selling their stock or liquidating the company.
  - The court refused the IRS's request to disregard that testimony as self-serving, because the court found their testimony credible and because documentary and other evidence supports that testimony.
- Documentary and other evidence supporting the unlikelihood of a liquidation was summarized by the court:

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

the family since its incorporation in 1932 also speaks loudly to the fact that the Cecil and the Pickering families are committed to maintaining TBC as a family business.

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

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

> I'm **gobsmacked-appalled-outraged**-about this case.
>
> …
>
> In short, ladies and gentlemen, we have a tax system that, at least at present, only effectively exists due to ***voluntary compliance*** by the overwhelming majority of taxpayers. But the system, including the IRS and the Tax Court, ***must work fairly and efficiently in order to give taxpayers confidence to voluntarily comply.***
>
> Make no mistake: **our tax system failed the Cecils.**
>
> …
>
> But in the 2010 gift tax audit, ***despite no changes in the Company's business operations or the family's clear desire to continue the Company's business (with mountainous supporting evidence-how many companies have you heard of with 300 YEAR plans?) since the 2005-2006 gift tax audits,*** the IRS gift tax auditor didn't feel bound by the settlement valuation formula to which the IRS had agreed in three prior gift tax audits of gifts in four separate taxable years, in favor of ***completely disregarding the Company's existence altogether as "lacking economic substance,"*** and the IRS valued the shares of Company stock using an *asset liquidation* approach. The result? A deficiency notice valuation resulting in a number ***four to five times the per share values of the 2010 gifts,*** which had been valued based on the previously agreed-to IRS settlement valuation formula.
>
> …
>
> … The undeniable effect of allowing the IRS to take such an outrageous, flimsy case to trial essentially is the ***flipside of the allegations from the IRS that taxpayers are playing the "audit lottery" and as equally reprehensible.***
>
> Three audits (gift tax returns for four different calendar years involved) in less than 12 years? I don't think that the word ***"shakedown"*** is an unfair word to say. [The writer described an overly aggressive agent in another situation], but IRS Appeals curbed his excessive exuberance, which, frankly, is what should've happened here***. In my opinion, this case should've never left IRS Appeals.***
>
> …
>
> … Make no mistake: if the IRS is allowed to take cases that aren't supported by admissible expert witness evidence to trial, ***the unmistakable effect is the IRS flipside of taxpayers playing the "audit lottery," forcing taxpayers to either litigate or settle based on sheer size of the deficiency, which erodes taxpayer confidence in our predominantly voluntary tax system, and, as such, equally reprehensible as the audit lottery.***
>
> Why did it take 2,558 days (more than ***seven years*** between trial and rendered decision/decision) to decide this case? That's a fair question, especially given that the case docket report reveals nothing apparent going on in the interim, especially given the slam-dunk taxpayer victory this case was?
>
> …
>
> **Conclusion**
>
> Houston, we have a problem. Steps must be taken to ensure that this never happens again.

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

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

a. **Overview.** Three cases in the last several years have provided insight to when the anticipatory assignment of income doctrine will apply when a gift of shares is made to charity that are sold by the charity soon after the contribution. One case allowed the donor to avoid recognition of gain (*Dickinson v. Commissioner*) but the other two (*Keefer v. United States* and *Hoensheid v. Commissioner)* held that the anticipatory assignment of income doctrine applied causing the donor to recognize the gain on the sale of shares. The latter two cases also denied an income tax charitable deduction (because of the charity's failure to provide an appropriate contemporaneous written acknowledgement or the donor's failure to attach a qualified appraisal to the income tax return claiming the deduction). The most recent of these three cases, *Hoensheid*, is discussed below. The other two are referenced briefly.

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

(1) **Synopsis.** Donor and his two brothers each owned-one-third of the shares of a Company, and they all decided to sell their shares when one brother wanted to retire. Donor expressed a desire to contribute some of his shares to a Fidelity donor advised fund (the DAF) "to avoid some capital gains," but wanted to "wait as long as possible to pull the trigger" because he did not want to own fewer shares than his brothers if the sale did not go through. His attorney warned about waiting too late to make the charitable gift, advising that "the transfer would have to take place before there is a definitive agreement in place." Donor later told his attorney "I do not want to transfer the stock until we are 99% sure we are closing." On June 11, 2015, the shareholders unanimously approved the sale of all of the shares to Purchaser and consented to Donor's donation of part of his shares to the DAF (but the number of shares to pass to the DAF was left blank). Various subsequent communications and documents from Donor continued not to specify the number of shares that would be donated to the DAF until a PDF stock certificate was emailed to the DAF on July 13, 2015. The final stock purchase agreement was signed by all the parties and the sale was closed two days later on July 15, 2015 in a "simultaneous close" transaction.

(a) **Date of Charitable Gift.** The court determined that the delivery of the gift to the DAF did not occur until July 13, 2015 when the PDF stock certificate was sent to the DAF. Fidelity sent a "corrected confirmation letter" and year end account statement stating that the shares were transferred (and presumably accepted) on June 11, 2015, but the court did not view that as credible and found that acceptance of the shares did not occur until July 13, the day the DAF received the stock certificate by email.

(b) **Anticipatory Assignment of Income Applied.** The court made clear that the test for whether the donor was treated as having sold the assets and as having recognized the gain before the charitable gift occurred is not whether the transfer occurred before the definitive purchase agreement was signed. Instead, the test is whether the transfer was made before Donors had an "already fixed or vested right to the unpaid income," looking to the realities and substance of the underlying transaction rather than to formalities or hypothetical possibilities.

The court looked to several specific factors in determining whether the sale of shares was "virtually certain to occur" at the time of the charitable gift: (1) any legal obligation to sell by the charitable donee; (2) actions already taken by the parties to effect the transaction; (3) any

remaining unresolved transactional contingencies; and (4) the status of corporate formalities required to finalize the transaction.

After examining those factors, the court concluded that "a donor must bear at least some risk at the time of contribution that the sale will not close." The court echoed prior decisions in not specifying a "bright line," test, but reasoned that the analysis of the four factors indicated that the delayed contribution in this case "eliminated any such risk and made the sale a virtual certainty." Other statements by the court: "already fixed or vested right"; sale was "virtually certain to occur"; "bonus payouts and distributions could not be clawed back"; written final consent was "a foregone conclusion"; no substantial "unresolved contingencies"; "formal shareholder approval was purely ministerial." Because the *Hoensheid* court ruled that the anticipatory assignment of income doctrine applied, the Donors were taxed on the gain attributable to the eventual sale of the donated shares.

(c) **Charitable Deduction Denied.** A charitable deduction for the gift of shares to the DAF was not allowed because the qualified appraisal requirement was not satisfied. The IRS listed a number of defects in the appraisal, with which the court did not take issue, and furthermore, the court determined that neither the doctrine of substantial compliance nor the statutory reasonable cause defense were sufficient under the facts of the case to excuse the defects. A primary factor was the failure to use a qualified appraiser and the treatment of June 11, 2015 as the transfer date. The appraisal was prepared for no additional charge by a representative of the investment banking firm used to structure the sale transfer. That representative did not hold himself out as an appraiser, had no certifications from a professional appraisal organization, and testified that he conducted valuations "briefly" and "on a limited basis."

(d) **Understatement Penalty.** The §6662(a) 20 percent understatement penalty for negligence or substantial understatement of income did not apply because Donors' attorney was a competent professional with sufficient expertise to justify reliance, and Donors adhered to her advice that "execution of the definitive purchase agreement" was the firm deadline for avoiding capital gains. While the attorney's substantive tax advice was incorrect, it was reasonable for Donors to rely on it.

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

(2) **Basic Facts.** Mr. Hoensheid (Donor) and his two brothers each owned one-third of CSTC (Company) that manufactured heat-treating metal fasteners for use in autos and other commercial vehicles. After one brother announced his intention to retire, the three brothers in the fall of 2014 decided to explore selling the Company. They concluded with their investment banking firm (Firm) that $80 million was a fair target price. In early 2015 the Firm began soliciting bids, and the ultimate purchaser (Purchaser) submitted a bid for $92 million on April 2, 2015.

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

Donor emailed his attorney that he and his wife wanted

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

The following is a brief chronology of activity leading up to the donation and sale.

- April 23, 2015 – Nonbinding letter of intent signed to sell the Company for $107 million.

- May 21, 2015 – Donor's attorney emailed him that a draft purchase and sale agreement had been drafted.
- May 22, 2015 – Donor signed an affidavit representing that the buyer had a "good faith intention of completing the transaction."
- June 1, 2015 – Donor signed a Letter of Understanding with the DAF describing the planned donation but not specifying the number of shares that would be donated.
- June 1, 2015 – Donor asked his attorney to prepare a shareholder consent agreement allowing him to give shares to the DAF but stated "I do not want to transfer the stock until we are 99% sure we are closing."
- June 11, 2015 – The shareholders unanimously approved the sale of all of their shares to Purchaser and consented to Donor's donation of part of his shares to the DAF (but the number of shares to pass to the DAF was left blank). Immediately after the shareholder meeting, the board of directors approved the transfer of some of Donor's shares to the DAF and agreed to distribute all balances in an Incentive Compensation plan prior to a recapitalization of the Company (which would occur as part of the sale process).
- June 12, 2015 – Sometime after the 6-11-15 board meeting, a stock certificate was prepared to transfer shares to the DAF, but Donor kept it on his desk until July 9 or 10 when he delivered it to his attorney.
- June 12, 2015 – Purchaser's investment committee and managing partners unanimously approved the acquisition subject to completion of their financial and business due diligence.
- June 15, 2015 – Donor emailed the signed shareholder agreement to his attorney and the number of shares to pass to the DAF was still left blank.
- July 1, 2015 – Purchaser's counsel prepared a revised draft of the stock purchase agreement that still left blank the number of shares being transferred to the DAF and prepared a minority stock purchase agreement with the DAF to purchase all of the shares transferred to the DAF.
- July 6, 2015 – Purchaser organized a new corporation to purchase the shares.
- July 6, 2015 – Donor emailed the attorney, stating "We are not totally sure of the shares being transferred to the charitable fund yet" but they would know more on Wednesday or Thursday of that week.
- July 7, 2015 – Donor emailed his wealth advisor that the Company would sweep the cash from the Company prior to closing and distribute it to the brothers and Donor executed a document specifying that the impending sale would trigger bonus payments to key employees.
- July 9, 2015 – The Company prepared a revised draft of the purchase agreement with a recital that "On July …, 2015 [petitioner] transferred 1,380 shares of Common Stock to" the DAF. (The ellipsis and bracketed insert are in the court's opinion.)
- July 10, 2015 – Purchaser prepared a revised draft of the stock purchase agreement that still left blank the date of transfer of shares to the DAF and proposed resolving an outstanding negotiating issue about an environment liability.
- July 10, 2015 – Three significant actions occurred. (1) About $6.1 million of employee bonuses were paid. (2) The Company's Article of Incorporation were amended as requested by Purchaser. (3) The attorney forwarded an updated draft of the minority stock purchase agreement to be signed by Fidelity for the DAF.
- July 13, 2015 – A revised stock purchase agreement was prepared that still left blank the date of the transfer of shares to the DAF. Later that morning, an advisor requested

Fidelity to sign the minority stock purchase agreement, but Fidelity responded that it must receive the stock certificate before it could sign that agreement. About 30 minutes later a PDF stock certificate was emailed to Fidelity. It was undated but stated that 1,380.40 shares were owned by the DAF. Later that day, the Company confirmed that 1,380 shares had been transferred to the DAF and Fidelity signed the minority stock purchase agreement agreeing to sell those shares to Purchaser.

- July 14, 2015 – Attorneys for the Company forwarded a revised draft of the stock purchase agreement stating that the contribution to the DAF was made on July 10, 2015. The Company made a dividend distribution of the remaining cash in the Company, about $4.8 million, to the brothers (none to the DAF).
- July 15, 2015 – The Purchaser, Company, and the three brothers signed the final stock purchase agreement (with the provision stating that 1,380 shares had been transferred to the DAF on July 10, 2015), and a representative of Fidelity signed a document assigning 1,380 shares to Purchaser in return for about $2.94 million.
- November 18, 2015 – Fidelity sent Donor and his wife an amended contribution confirmation letter acknowledging a contribution of 1,380.400 shares on June 11, 2015, stating that Fidelity had exclusive control over the shares and that it provided no goods or services in exchange for the contribution.

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

A notice of deficiency disallowed the claimed charitable deduction and applied a penalty under §6662(a). Donor filed a petition with the Tax Court contesting the disallowance of the charitable deduction and penalty. The IRS's amended answer in the Tax Court proceeding for the first time asserted that Donor made an anticipatory assignment of income and should have reported the income with respect to the sale of the 1,380 shares that had been transferred to the DAF and applied the §6662(a) penalty attributable to the anticipatory assignment of income rather than the disallowed charitable deduction.

(3) **Issues.**

(1) Whether and when Donors contributed shares to the DAF.

(2) Whether Donors had unreported capital gain income "due to their right to proceeds from the sale of those shares becoming fixed before the gift."

(3) Whether Donors are entitled to a charitable contribution deduction.

(4) Whether Donors are liable for an accuracy-related penalty under §6662(a).

(4) **Whether and When Donor Contributed to the DAF.**

(a) **Intent.** A valid gift under Michigan law requires (1) donor intent to make a gift, (2) actual or constructive delivery, and (3) donee acceptance.

Various communications and documents beginning mid-April, 2015 evidenced an intent by Donor to make a gift of shares to the DAF, including a unanimous shareholder approval on June 11, 2015, to sell all of the Company shares and consenting to a charitable contribution of some unspecified number of shares to the DAF. However, a present intent to make a gift did not occur until July 9, 2015, when Donor settled on a number of 1,380 shares.

(b) **Delivery.** No specific action occurred on June 11 placing shares within the DAF's dominion and control. Indeed, Donor kept the stock certificate for transferring shares to the DAF in his office until July 9 or 10, at which point he delivered it to his attorney. An email of a PDF stock certificate to Fidelity on July 13 provided "the strongest documentary evidence of the shares' leaving [Donor's] dominion and control," evidencing "an open and visible change of possession."

(c) **Acceptance.** Fidelity sent an amended contribution confirmation letter acknowledging a contribution of 1,380.400 shares and a year-end account statement stating that the shares were transferred (and presumably accepted) on June 11. However, Donor did not produce the original contribution confirmation letter dated July 15 that could have confirmed whether Fidelity consistently understood the date of the contribution to be June 11 and what errors were present in the original letter. An email from Fidelity on July 13 stating it would have to receive the stock certificate before it could take action to sell the shares to Purchaser was the more convincing evidence. **Acceptance occurred on July 13, 2015.**

(5) **Anticipatory Assignment of Income.** The court looked to its two-part test from more than 50 years earlier in *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964). In that case the court respected "the form of this kind of transaction [i.e., as a donation of shares followed by the charity's redemption of the shares rather than as a sale of shares by the taxpayer followed by a donation of the cash proceeds] if the donor (1) gives the property away absolutely and parts with title thereto (2) before the property gives rise to income by way of a sale."

The determination that the charitable gift was made on July 13, 2015, satisfied the first prong, leaving the issue of whether the gift occurred early enough to satisfy the second prong.

The test applied by the court for that "early enough" issue is whether the "donor [had] an already fixed or vested right to the unpaid income." The court looked at several factors in determining whether the "fixed or vested" right to income had occurred before the charitable gift.

(1) The DAF did not have a legal obligation to sell the shares. (While Rev. Rul. 78-197 viewed the donee's obligation to sell the donated assets as supporting an anticipatory assignment of income finding, the court did not view that as the only factor to be considered.)

(2) Numerous actions already taken by the parties suggest the sale was a virtual certainty. These include the creation of a new holding company by Purchaser to purchase the shares, amendment of the Company's Articles of Incorporation as requested by Purchaser, and various "cash sweeping" transactions that emptied the Company of its working capital (the court viewed the cash sweeping transactions as "strongly" suggesting the sale to Purchaser was a "virtual certainty" before the charitable gift on July 13).

(3) Any unresolved sale contingencies that still existed on July 13 were not "substantial enough to have posed even a small risk of the overall transaction's failing to close."

(4) Corporate formalities required to finalize the transaction were sufficiently completed for this to be a neutral factor. While the Company and shareholders did not sign the final purchase agreement until two days after the charitable gift, "final written consent was a foregone conclusion." The selling shareholders were receiving a substantial premium over their initial target price. All three brothers, and especially Donor, were involved in negotiating the transaction, making their approval "all but assured" as of July 13. The court found that "formal shareholder approval was purely ministerial, as any decision by the brothers not to approve the sale, was as of July 13, 'remote and hypothetical.'"

The court also observed that the reasoning in *Dickinson v. Commissioner*, T.C. Memo. 2020-128 did not require a different result. That court summarized that the assignment of income doctrine applies only if (1) the redemption was practically certain to occur at the time of the gift, and (2) would have occurred whether the shareholder made the gift or not. In *Dickinson*, the redemption occurred only because the charitable gift was made (resulting from Fidelity's established practice of immediately selling closely-held shares after receiving them) and the shares would not have

been redeemed otherwise. In *Hoensheid*, on the other hand, the shares would have been sold to Purchaser even if the shares had not been given to the DAF before the sale closing.

The court's conclusion is an excellent summary of the anticipatory assignment of income analysis regarding charitable gifts.

> To avoid an anticipatory assignment of income on the contribution of appreciated shares of stock followed by a sale by the donee, a donor **must bear at least some risk at the time of contribution that the sale will not close**. On the record before us, viewed in the light of the realities and substance of the transaction, we are convinced that petitioners' delay in transferring the CSTC shares until two days before closing **eliminated any such risk and made the sale a virtual certainty**. Petitioners' right to income from the sale of CSTC shares was thus fixed as of the gift on July 13, 2015. We hold that petitioners recognized gain on the sale of the 1,380 appreciated shares of CSTC stock.
>
> We echo prior decisions in recognizing that our holding **does not specify a bright line** for donors to stop short of in structuring charitable contributions of appreciated stock before a sale. See *Allen*, 66 T.C. at 346 (rejecting proposed bright-line rule approach and noting that "drawing lines is part of the daily grist of judicial life"); see also *Harrison v. Schaffner*, 312 U.S. 579, 583–84 (1941). However, as petitioners' tax counsel seems to have recognized in her advice to petitioner, "any tax lawyer worth [her] fees would not have recommended that a donor make a gift of appreciated stock" so close to the closing of a sale. *Ferguson v. Commissioner*, 174 F.3d at 1006; see *Allen*, 66 T.C. at 346 (recognizing that realities and substance approach puts "a premium on consulting one's lawyer early enough in the game"). By July 13, 2015, the transaction with HCI **had simply "proceeded too far down the road to enable petitioners to escape taxation on the gain attributable to the donated shares**." *Allen*, 66 T.C. at 348.

T.C. Memo. 2023-34 (emphasis added).

(6) **Charitable Deduction Contribution.**

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

The contemporaneous written acknowledgement requirement was satisfied. The acknowledgement must be received before the relevant tax return was required or, if earlier, the due date of the return. For a gift to a donor advised fund, the written acknowledgement must state that the donee "has exclusive legal control over the assets contributed." §170(f)(18). The acknowledgement met the requirements, but the IRS argued that the acknowledgement said the charity received "shares" rather than cash, and for income tax purposes Donors were treated as effectively recognizing the income before the transfer. The court disagreed with the IRS's argument, noting that the acknowledgement correctly identified shares that were actually transferred to the DAF and that the acknowledgement does not have to describe correctly how the interest is classified for federal tax purposes.

The qualified appraisal requirement was not satisfied. The IRS listed a number of deficiencies in the appraisal (illustrating how strictly the IRS applies those requirements).

> Respondent contends that petitioners' appraisal is not a qualified appraisal because it (1) did not include the statement that it was prepared for federal income tax purposes; (2) included the incorrect date of June 11 as the date of contribution; (3) included a premature date of appraisal; (4) did not sufficiently describe the method for the valuation; (5) was not signed by Mr. Dragon or anyone from FINNEA; (6) did not include Mr. Dragon's qualifications as an appraiser; (7) did not describe the property in sufficient detail; and (8) did not include an explanation of the specific basis for the valuation. Aside from petitioners' already rejected claim that the June 11 date of contribution was correct, petitioners do not meaningfully dispute that their appraisal had at least some defects.

Donors argued that "the doctrine of substantial compliance and the statutory reasonable cause defense" excused any defects.

As to substantial compliance, the court found especially important that the appraiser was not a qualified appraiser. The appraisal did not state the appraiser's qualifications, he did not hold himself out as an appraiser, he had no certifications from a professional appraisal organization, and he testified that he conducted valuations "briefly" and only "on a limited basis" (once or twice a year to solicit business for prospective clients). The discrepancy in the stated date of

contribution (June 11 vs. July 13) was also significant because of various substantial distributions from the Company occurring between those dates.

The court also found that the reasonable cause exception did not apply because Donors could not show reliance on the appraisal in good faith. Donors decided to rely on a free appraisal prepared by a representative of the Firm who had limited experience rather than engage a national accounting firm on a paid basis. Also, Donor's statements in various emails and retention of the undated physical stock certificate strongly suggest Donor knew or should have known that the shares were not contributed on June 11.

Accordingly, the charitable deduction was disallowed.

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

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

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

The relevant issue was different from the reason for the finding that no reasonable cause existed for the failure to comply with the qualified appraisal requirement.

> Accordingly, respondent must show that (1) [Donor's attorney] was not a competent professional with sufficient expertise to justify reliance; (2) petitioners failed to provide her with necessary and accurate information; or (3) petitioners did not actually rely in good faith on her judgment.

The court reasoned that while Donors failed to follow their attorney's cautionary note about timing, "they did adhere to the literal thrust of her advice: that 'execution of the definitive purchase agreement' was the firm deadline to contribute the shares and avoid capital gains." While the attorney's advice about the substantive tax law was incorrect, Donors could reasonably rely on it (citing *United States v. Boyle*, 469 U.S. 241 (1985)).

The court concluded that the IRS failed to establish that Donors did not have reasonable cause for the understatement of income and refused to apply the §6662(a) 20% penalty.

(8) **Observations.**

(a) **Expanded Anticipatory Assignment of Income Analysis.** The court provides a very detailed expansive analysis of the anticipatory assignment of income issue, focusing on whether the charitable transfer was made early enough before the right to income arose (the second prong of the *Humacid* test). The court made clear that the test is not whether the transfer occurred before the definitive purchase agreement was signed. Instead, the test is whether the transfer was made before Donors had an "already fixed or vested right to the unpaid income" looking to the realities and substance of the underlying transaction rather than to formalities or hypothetical possibilities.

The court looked to several specific factors in determining whether the sale of shares was "virtually certain to occur" at the time of the charitable gift: (1) any legal obligation to sell by the charitable donee; (2) actions already taken by the parties to effect the transaction; (3) any remaining unresolved transactional contingencies; and (4) the status of corporate formalities required to finalize the transaction.

After examining those factors, the court concluded that "a donor must bear at least some risk at the time of contribution that the sale will not close." The court echoed prior decisions in

not specifying a "bright line," test, but reasoned that the analysis of the four factors indicated that the delayed contribution in this case "eliminated any such risk and made the sale a virtual certainty."

(b) **First Prong of *Humacid* Test Might Also Have Been a Basis for the Anticipatory Assignment of Income Result.** Interestingly, the court did not have any extended detailed analysis of the first prong of the *Humacid* test, but the "partial interest" analysis of that first prong might also have been applicable in *Keefer*. The *Keefer* court concluded that the first prong was not satisfied because Donor retained some disproportionate right to partnership assets and did not transfer all rights under a 4% limited partnership interest that was assigned to charity. Similarly, in *Hoensheid*, Donors transferred 1,380 shares to the DAF, but they apparently retained various rights to dividend payments that generally would have been attributable to those shares. The Company made various distributions characterized as dividends after the transfer of shares to the DAF, and those dividend distributions were made just to the three brother-shareholders and not to the DAF.

(c) **Inconsistent With Result of Rev. Rul. 78-197 and *Rauenhorst v. Commissioner*.** *Hoensheid* (and *Dickinson v. Commissioner* discussed in Item 26.d below reasoned there is no "bright line" test to determine when the assignment of income doctrine applies. *Hoensheid* briefly addressed the court's prior discussion of Rev. Rul. 78-197, 1978-1 C.B. 83 (which has been viewed by the Tax Court as a "bright line" test), and *Rauenhorst v. Commissioner*, 119 T.C. 157 (1993) (discussed below). The *Hoensheid* court distinguished Rev. Rul. 78-197 and *Rauenhorst* by saying that the Tax Court has not adopted Rev. Rul. 78-197 and the anticipatory assignment of income test and quoting the statement in *Dickinson v. Commissioner*, T.C. Memo. 2020-128, that "[f]or a taxpayer to rely on a revenue ruling, the facts of the taxpayer's transaction must be 'substantially the same as those considered in the revenue ruling.'" Those statements are followed by this, as the complete analysis of the court's conclusion as to why Rev. Rul 78-197 does not apply:

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

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

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

Despite the court's attempt to distinguish *Rauenhorst* and Rev. Rul. 78-197, the court's approach in *Hoensheid* seems very inconsistent with the result in *Rauenhorst*. First some background.

In *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd on another issue*, 523 F.2d 1308 (8th Cir. 1975), the taxpayer had voting control of a corporation and foundation. The taxpayer donated shares of stock to the foundation and the following day caused the corporation to redeem the foundation's shares. When the foundation received the stock, no vote for the redemption had been taken, and the foundation had the voting power to prevent the redemption. The Tax Court refused to apply the assignment of income doctrine (to treat the donor as having sold the stock and contributed the sale proceeds to the foundation) because the foundation was not a sham or the alter ego of the taxpayer, the transfer to the foundation was a valid gift, and the foundation was not "powerless to reverse the plans of the petitioner."

The IRS acquiesced in *Palmer* in Rev. Rul. 78-197. The ruling discussed a charitable contribution followed by a prearranged redemption. The ruling briefly summarized *Palmer* and concluded that the Tax Court had recognized the transfer of stock (rather than sale proceeds) to the foundation in *Palmer* because the foundation was not a sham, the transfer of stock was a valid gift, and "the foundation was not bound to go through with the redemption at the time it received title to the shares." The ruling concluded: "The Service will treat the proceeds of a redemption of stock under facts similar to those in *Palmer* as income to the donor only if one is legally bound, or can be compelled by the corporation, to surrender the shares for redemption."

Rauenhorst involved a contribution of stock warrants to charities which seven days later agreed to sell them to a purchaser who was going to purchase all the stock of the corporation. The IRS argued that the donor's right to receive the sale proceeds from the stock sale had "ripened to a practical certainty" at the time of the assignments, and the assignment of income doctrine should apply. The court summarized Rev. Rul. 78-197 as establishing a "bright-line" test:

> The Internal Revenue Service (IRS), in Rev. Rul. 78-197, 1978-1 C.B. 83, acquiesced to our decision in *Palmer v. Commissioner, supra,* and in doing so devised a "bright-line" test which focuses on the donee's control over the disposition of the appreciated property. …

119 T.C. at 165.

The court then stated that it had not adopted the bright-line test of Rev. Rul. 78-197.

> [W]e have indicated our reluctance to elevate the question of donee control to a talisman for resolving anticipatory assignment of income issues. For example, in *Allen v. Commissioner,* 66 T.C. 340, 347-348 (1976), we stated that the donee's power to reverse the donor's anticipated course of disposition "is only one factor to be considered in ascertaining the `realities and substance of the transaction.'" Cf. *Jones v. United States,* 531 F.2d 1343, 1346 (6th Cir. 1976). In a more recent opinion, we further extrapolated our position as follows:
>
> > In determining the reality and substance of a transfer, the ability, or the lack thereof, of the transferee to alter a prearranged course of disposition with respect to the transferred property provides cogent evidence of whether there existed a fixed right to income at the time of transfer. Although control over the disposition of the transferred property is significant to the assignment of income analysis, the ultimate question is whether the transferor, considering the reality and substance of all the circumstances, had a fixed right to income in the property at the time of transfer. [*Ferguson v. Commissioner,* 108 T.C. at 259; citations omitted.]
>
> This Court has not adopted the "bright-line" test stated in Rev. Rul. 78-197, *supra,* as the test for resolving anticipatory assignment of income issues, and instead we have considered the donee's control to be merely a factor, albeit an important factor.

119 T.C. at 166.

The IRS argued that the appropriate test was whether the sale was a "practical certainty" before the contribution, which the court viewed as an abandonment by the IRS of its "legally obligated" test from Rev. Rul. 73-197: "When respondent's arguments are boiled down to their essential elements, he argues against the validity of the bright-line test of Rev. Rul. 78-197 …."

The court stated, in very forceful terms, though, that the IRS was bound to follow its own revenue rulings.

> Respondent's counsel may not choose to litigate against the officially published rulings of the Commissioner without first withdrawing or modifying those rulings. The result of contrary action is capricious application of the law. [Quoting *Phillips v. Commissioner,* 88 T.C. at 529, 534 (1987).]

119 T.C. at 172.

Thus, although the *Rauenhorst* court stated that it did not adopt the bright-line test in Rev. Rul. 78-197, because it viewed the IRS's position as contrary to its own revenue ruling, the court proceeded to decide the case based on "whether the charitable donees were legally

obligated or could be compelled to sell the stock warrants at the time of the assignments." The Tax Court reasoned that Rev. Rul. 78-197 had been in existence nearly 25 years without being revoked or modified and the taxpayers relied on that ruling in planning their charitable contributions. The IRS pointed to various facts suggesting that the right to the sale proceeds had "ripened to a practical certainty" before the transfer to the charity, but the court viewed that as unimportant:

> Those items might be particularly relevant for determining whether the stock warrant purchase ripened to a practical certainty; however, none of those items alone, or in combination, show that the donees were legally bound, or could be compelled, to sell their stock warrants.

That reasoning would suggest that in Tax Court litigation the court should apply the legally obligated "bright-line" test in any case in which the IRS argues that a "practical certainty" test or any test other than the legally obligated test should govern to determine whether there is an assignment of income if assets contributed to charity are sold soon after by the charity.

Although the "virtually certain to occur" approach in *Hoensheid* is consistent with the Court's statement in *Rauenhorst* that it does not adopt the legally obligated test as the proper approach, the approach in *Hoensheid* seems hard to reconcile with the analytical approach in and result of *Rauenhorst* (again, a full Tax Court opinion).

(d) **A Tax Court Case Basing a Holding on the Burden of Proof.** Tax Court cases very frequently mention which party has the burden of proof as to particular issues, but go on to say that it does not matter in the particular case because the court is making its decision based on a preponderance of the evidence. *Hoensheid* is an example of a case in which one of the holdings (the penalty issue) apparently was based on the IRS not meeting its burden of proof (i.e., "respondent has failed to establish").

c. **Assignment of Income Applied and Charitable Deduction Denied, *Keefer v. United States***

Keefer v. United States held that the assignment of income doctrine applied because a partial interest in assets, rather than the "entire asset," was conveyed to charity before its sale of the asset. The charitable deduction was denied because the acknowledgement from the donor advised fund did not say the DAF had exclusive legal control over the assets contributed (which is one of the required substantiation requirements for charitable gifts to a DAF). *Keefer v. United States*, 130 AFTR 2d 2022-5406 (N.D. Tex. August 10, 2022) (denying motion for reconsideration of Order (130 AFTR 2d 2022-5002 (July 6, 2022)) denying charitable deduction for failure to meet contemporaneous written acknowledgement requirement).

For further discussion of *Keefer*, see Item 27.c of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

d. **No Assignment of Income, *Dickinson v. Commissioner*.**

The court summarized that the assignment of income doctrine applies in the context of this fact situation "only if" (1) "the redemption was practically certain to occur at the time of the gift, and" (2) "would have occurred whether the shareholder made the gift or not."

The first leg was probably satisfied on these facts, in light of Fidelity's strict written policy that it would immediately sell donated stock. But the second leg was not satisfied. The taxpayer made charitable gifts on three occasions (which Fidelity immediately sold pursuant to its policy), but there was no indication whatsoever that the taxpayer would have sold shares to the corporation if the shares had not been donated to the Gift Fund.

Dickinson v. Commissioner, 130 AFTR 2d 2022-5002 (July 6, 2022) 130 AFTR 2d 2022-5405 (N.D. Tex. August 10, 2022) (denying motion for reconsideration))

For a more detailed summary of *Dickinson v. Commissioner* and its analysis of the assignment of income doctrine, see Item 30 of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

27. Successor Trustee of Revocable Trust and Trust Beneficiaries, Who Were Appointed and Received Distributions After Decedent's Death, Were Personally Liable for Unpaid Estate Taxes, *United States v. Paulson*, 131 AFTR 2d 2023-1743 (9th Cir. May 17, 2023), *cert. denied* (U.S. March 4, 2024) (No. 23-436)

a. **Synopsis.** The decedent died in 2000 with most of his assets in a revocable living trust. The executors filed the estate tax return; they paid some estate tax and deferred the rest under §6166. The IRS and the estate in 2005 agreed to a much higher estate tax, which was deferred under §6166. Most of the estate tax was never paid. Distributions were made to various trust beneficiaries between 2003 and 2006. Various family members were appointed as successor trustees in 2009 and 2011.

In 2015, the IRS filed an action against the estate and living trust for the balance of the estate tax liability (then over $10 million). The IRS also sought judgment under §6324(a)(2) against various family members in their capacities as successor trustees and as beneficiaries.

The district court made various determinations, including that certain individuals were not liable as transferees or trustees because they were not in possession of estate property at the time of the decedent's death.

The Ninth Circuit Court of Appeals reversed that decision. This is the **first case** holding that personal liability under §6324(a)(2) is extended to successor trustees and trust beneficiaries who are appointed or receive property *after* the decedent's death (in this case, years later). (Over the last 70 years, prior cases held that §6324(a)(2) and its predecessors applied only to specified classes of individuals who hold or receive (or have the right to immediate receipt of) property in the gross estate at the time of the decedent's death.) In addition, the court held that "beneficiaries" who are personally liable under 6324(a)(2) include trust beneficiaries, not just life insurance or annuity beneficiaries.

A dissenting opinion viewed the majority's analysis as a "hypertechnical reading" of statutory language (applying the "rule of the last antecedent" because of the lack of a comma after a particular word) that results in an interpretation with illogical results. The illogical result is that individuals may become successor trustees or receive distributions at a time after values have declined so much that their personal liability for estate tax exceeds the value of the property when received. The IRS made "avowals" in briefs and oral argument that it would not pursue that "excess" liability, but those "avowals" are not binding in future cases.

The conclusion of the majority opinion is that successor trustees who are appointed after the decedent's death and trust beneficiaries who receive trust distributions after the decedent's death are personally liable for estate taxes under §6324(a)(2), but the personal liability of successor trustees is capped at "the value of the property at the time that they received or had it as trustees," and the personal liability of trust beneficiaries "cannot exceed the value of the estate property at the time of decedent's death, or the value of that property at the time they received it."

United States v. Paulson, 131 AFTR 2d 2023-1743 (9th Cir. May 17, 2023), *cert. denied* (U.S. March 4, 2024) (No. 23-436).

b. **Facts.** Allen Paulson ("Allen"), who was an executive of Gulfstream Aerospace Corp., died July 19, 2000. Nearly all his assets were held in a revocable living trust. When Allen died, his son John Michael Paulson became co-trustee and was appointed co-executor.

In October 2001, John became sole executor and co-trustee with a different co-trustee. That month, John filed an estate tax return reporting a total gross estate of $187.7 million, a net taxable estate of $9.2 million, and an estate tax liability of $4.5 million. The estate paid about $700,000 and deferred the balance under §6166.

The IRS audited the estate tax return. Eventually the Tax Court (in December 2005) entered a stipulated decision determining that the estate owed an additional $6.7 million of estate tax, which the estate elected to defer under §6166. The executor made one estate tax and interest payment in 2007 and made some other interest payments. No one paid any subsequent installment payments.

The executor made distributions to Allen's widow in 2003 (worth between $19 million and $42 million) and to other beneficiaries (including Allen's granddaughter, Crystal Christensen) of at least $7.3 million between 2003 and 2006.

Various disputes arose among the beneficiaries. In 2009 the probate court removed John Michael Paulson as co-trustee of the living trust for misconduct and appointed Vikki Paulson (the widow of Allen's son who died after Allen's death) and James Paulson (one of Allen's sons) as successor co-trustees. The IRS asserted that the living trust contained assets at that time worth more than $13.7 million (which exceeded the estate tax liability). Vikki and Crystal claimed the trust was insolvent at that time but agreed that the trust assets exceeded the tax liability. In 2011, the probate court appointed Crystal as co-trustee with Vikki. The IRS asserted that the living trust assets were worth at least $8.8 million at that time. In January 2013, the family members resolved disputes among themselves and entered into a settlement agreement, pursuant to which John Michael Paulson received various assets in exchange for resigning as executor. Vikki and Crystal asserted that the living trust by that time was "completely depleted."

In 2015, the IRS filed an action against the estate and living trust for the balance of the estate tax liability (then over $10 million). The IRS also sought judgment under §6324(a)(2) against all the individuals named above in their individual and representative capacities.

The district court entered various findings, including that Vikki Paulson and Crystal Christensen were not liable as transferees or trustees because they were not in possession of estate property at the time of Allen's death. *United States v. Paulson*, 204 F. Supp. 3d 1102, 118 AFTR 2d 2016-5665 (S.D. Calif. 2016). The district court's determination was appealed to the Ninth Circuit Court of Appeals.

c. **Holding.** The Ninth Circuit Court of Appeals reversed that determination and remanded to the district court to determine the amount of each defendant's liability for unpaid taxes.

(1) **Interpretation of §6324(a)(2)**. Section 6324(a)(2) imposes personal liability for unpaid estate taxes on categories of persons listed in the statute (including a surviving joint tenant, transferee, trustee, or beneficiary) who (1) *receive* estate property *on or after* the date of the decedent's death, or (2) have estate property on the date of the decedent's death.

(2) **Application of Interpretation of §6324(a)(2) to Facts.** James Paulson and Vikki Paulson (who became successor co-trustees nine years after Allen's death) and Crystal Christensen (who became successor co-trustee eleven years after Allen's death) are liable, **as trustees**, for unpaid estate taxes on property from the gross estate held in the living trust, capped at the value of estate property in the living trust at the time of Allen's death, but each defendant's "liability cannot exceed the value of the property at the time that they received or had it as trustees." 131 AFTR 2d 2023-1743, at 1758.

In addition, Crystal Christensen and Madeleine Pickens are liable as **trust beneficiaries** under §6324(a)(2) for unpaid estate taxes, but their liability "cannot exceed the value of the estate property at the time of [Allen's] death or the value of that property at the time they received it." 131 AFTR 2d 2023-1743, at 1762. (Crystal received some property as a trust beneficiary between 2003 and 2006, years before she became successor co-trustee, and her liability as to that property, capped at the value of such property on the date of her receipt, would be different than her liability as trustee capped at the value of the living trust assets when she became successor co-trustee some years later.)

d. **Majority Opinion Analysis.**

(1) **Overview.** The court's analysis focused on two issues regarding what persons are subject to personal liability under §6324(a)(2) in the factual context of certain individuals (who were either successor co-trustees or beneficiaries, or both).

First, does §6324(a)(2) apply to specified persons who receive property after the date of the decedent's death in addition to persons who have property at the time of the decedent's death? The 2-judge majority concluded that it does, contrary to the prior accepted interpretation of the statutory language. A dissent by the remaining judge argues strongly that it does not, which would have meant the individuals were not personally liable for the unpaid estate tax.

Second, does the reference to "beneficiaries" in §6324(a)(2) include trust beneficiaries? (The court concluded that it does, contrary to prior cases that would limit the term to beneficiaries of life insurance or annuities.)

In addition, the court limited the personal liability to the lesser of (1) the value of assets on the date of death that were later received as beneficiaries or accepted as trustees or (2) the value of such assets when received or accepted, even though the statute merely provides the first limitation.

(2) **Section 6324(a)(2).** The IRS asserted personal liability of successor trustees and trust beneficiaries under §6324(a)(2). (As discussed below, another possible statutory remedy for personal liability is "transferee liability" under §6901, but the IRS did not assert personal liability under §6901.)

Section 6324(a)(2) provides as follows:

> If the estate tax imposed by chapter 11 is not paid when due, then the spouse, transferee, trustee [with one exception not relevant], surviving tenant, person in possession of the property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax. …

The relevant parts of §6324(a)(2) (split apart into the relevant clauses that are numbered for convenience in referring to the clauses) for the *Paulson* facts are:

[1] "If the estate tax … is not paid, then

[2] the … trustee, … or beneficiary,

[3] who receives, or has *on the date of the decedent's death*, property included in the gross estate under sections 2034 to 2042, inclusive,

[4] to the extent of the value, at the time of the decedent's death, of such property,

[5] shall be personally liable for such tax…"

Comment: Prior to *Paulson*, this provision has been interpreted as follows:

> the only persons who have primary personal liability for the estate tax should be (1) the executor (and not the probate estate heirs), and (2) the non-probate estate fiduciaries and beneficiaries (using that term broadly) who hold or receive (or have the right to immediate receipt of) the property as of the death date, up to the value of the property on that date.

Jasper L. Cummings, *Scalia's Rules and Tax Collection*, 181 TAX NOTES FEDERAL 2179, at section I.B (Dec. 18, 2023) (hereafter "Cummings Article"). The Cummings Article derives its title from Antonin Scalia & Bryan A. Garner, READING LAW: THE INTERPRETATION OF LEGAL TEXTS (2012), a book about statutory interpretation co-authored by the late Supreme Court Justice Antonin Scalia that was cited several times in the *Paulson* majority opinion.

(3) **"On the Date of the Decedent's Death" Issue**. The court applies a detailed statutory construction analysis to determine whether the phrase "*on the date of the decedent's death*" refers to both "receives" and "has" or refers only to "has." The government argued that it refers only to "has" so the statute imposes personal liability on the specified persons who "(1) receive estate property at any time on or after the date of the decedent's death, or (2) have estate property on the date of the decedent's death." Therefore, the statute imposes personal liability on "successor trustees or beneficiaries of the living trust, including those who have or received estate property after the date of" Allen's death. The court agreed with the government's interpretation, with a very detailed analysis of construction principles.

Observation: The court got bogged down with its detailed technical rules-of-construction analysis. A "natural reading" of the sentence, with its "or has on the date of the decedent's death " clause set off by commas, is that the "on the date of the decedent's death" limitation applies only to property a person "has" on the date of death and not property that the person "receives." A possible interpretation of the intent of the statute is that it begins with the notion of a person "who receives property included in the gross estate under section 2034 to 2042 inclusive." But it is possible that a person would not have to "receive" the property because the person might already "have" it – especially for property described in §2034 to §2042, which focus on transfers made before death that "ripen" into possession or at least some type of vested interest at death. To close that gap, the statute adds "or has on the date of the decedent's death," appropriately set off by commas at both the beginning and the end.

The problem with that common sense interpretation of the statute, as pointed out by the taxpayers (discussed immediately below), is that the personal liability could exceed the value "received" at the time of receipt, which creates an ambiguity that should be resolved by focusing on the legislative intent. As discussed below, the majority "fixes" that problem by limiting the personal liability to the value at the time of the receipt, even though the statute does not say that.

The taxpayers argued that interpreting the statute to refer to any persons who receive gross estate property at any time after the decedent's death leads to absurd results because that (1) could make purchasers of property liable for unpaid estate tax and (2) could result in personal liability for estate tax that exceeds the value of property when it is later received.

As to the first example, the majority responded that §6324(a)(2) by its terms does not apply to purchasers (they are not one of the six categories of listed persons, and the last sentence of §6324(a) specifically addresses the effect of a transfer to a purchaser).

The court's discussion of the second example results in a very important caveat in the court's final description of its interpretation of the statute. This example relates to clause [4] of §6324(a)(2) as described above, limiting liability to "the value, at the time of the decedent's death, of such property." The court discusses a number of events that would have to occur before a person who later receives gross estate property would have liability that exceeds the value the property at the time it is first received by the person. The most important of the contingencies that would have to occur is that the IRS "would seek to impose tax liability on a transferee, beneficiary, or other recipient of estate property in an amount that exceeds the value of the property they received." The court relied on the "government's avowals in its briefing and at oral argument that estate tax liability cannot exceed the value of the property received" and that "a person's liability is capped at the value of the property had or received." 131 AFTR 2d 2023-1743, at 1755. The majority believed that the government would be judicially estopped from asserting such excess liability on any of the parties in this case and that no cases have been identified in which the government attempted to impose personal liability for estate taxes that exceeded the value of the property received.

The court acknowledged that two prior cases rejected the government's interpretation of the statute limiting liability to the value of property when received or accepted. *Englert v. Commissioner*, 32 T.C. 1008 (1959) (interpreting a predecessor statute to §6324(a)(2)); *United States v. Johnson*, No. CV 11-00087, 2013 U.S. Dist. LEXIS 106671, 2013 WL 3924087 (D. Utah 2013). The court rejected the reasoning of both cases as superficial. No prior case has accepted the government's position, so this is the first and only case to adopt the court's interpretation of §6324(a)(2).

(4) **Interpretation of "Beneficiary" to Include Trust Beneficiaries.** The taxpayers argued that the reference to "beneficiaries" in §6324(a)(2) does not include trust beneficiaries but the term as used in §6324(a)(2) refers to life insurance beneficiaries. (Presumably they would also acknowledge that it includes beneficiaries of annuities included in a decedent's gross estate under §2039.)

As another "first," the court for the first time reaches the conclusion that trust beneficiaries who receive property after a decedent's death have personal liability under §6324(a)(2). The court refers to two construction principles in the discussion of the meaning of "beneficiary": (1) "the word's ordinary meaning;" and (2) "presumption of consistent usage."

The taxpayers pointed to two cases in 1934 and 1959 interpreting predecessor versions of the statute that interpreted "beneficiaries" to include just life insurance beneficiaries (*Higley v. Commissioner*, 69 F.2d 160 (8th Cir. 1934); *Englert v. Commissioner*, 32 T.C. 1008 (1959)), and two more recent cases (1994 and 2013 cases) applying the reasoning of those cases to interpret §6324(a)(2). The majority opinion distinguished the cases interpreting predecessor statutes based on differences in the predecessor statutes. 131 AFTR 2d 2023-1743, at 1759-1760. The court rejected the conclusion of the 1994 case, *Garrett v. Commissioner*, T.C. Memo. 1994-70, because of its superficial acceptance of the reasoning of the prior cases despite the differences in the predecessor statutes. (One commentator critical of *Paulson* counters that "the law did change but not in a material way." Cummings Article at section III.B.2.) The court did not address the analysis of this issue in the more recent district court case that also reached a contrary result, *United States v. Johnson*, 2013 U.S. Dist. LEXIS 106671, 2013 WL 3924087 (D. Utah 2013).

(5) **Conclusion of Interpretation of §6324(a)(2) and Finding that Successor Co-Trustees and Trust Beneficiaries Who Became Co-Trustees and Received Assets After the Date of Death Are Personally Liable, But with a Cap on the Personal Liability.** The court concluded that the successor co-trustee had personal liability for the unpaid estate taxes and two of the trust beneficiaries who received trust assets years after the decedent's death also had personal liability for the unpaid estate tax, but with a cap on the degree of their personal liability.

> We conclude that the ordinary meaning of beneficiary, which includes trust beneficiaries, applies to § 6324(a)(2), and we are not persuaded that the structure or context of the statute, or policy considerations, require a narrower interpretation as the defendants argue. Moreover, applying the presumption of consistent usage further supports our conclusion that the term beneficiary in the tax code includes trust beneficiaries. Therefore, we conclude that Crystal Christensen and Madeleine Pickens are liable for the unpaid estate taxes under § 6324(a)(2) as beneficiaries. However, the liability of each of these defendants cannot exceed the value of the estate property at the time of decedent's death, or the value of that property at the time they received it.

131 AFTR 2d 2023-1743, at 1761-1762.

The cap on each person's personal liability is not to "exceed the value of the estate property at the time of decedent's death, or the value of that property at the time they received it."

The Ninth Circuit remanded the case to the district court for further proceedings "necessary to determine the amount of each defendant's liability of the unpaid taxes."

e. **Dissent Analysis.** The following is a discussion of the dissent by Judge Ikuta. It is an extensive discussion because the dissent provides a persuasive rebuttal to the majority opinion and is consistent with the interpretation that has been applied to the statute and its predecessors for 70 years.

The dissent begins with the importance of determining the Congressional intent of §6324(a)(2), and if a statute is ambiguous, the court must consider "the most logical meaning" of the statute (quoting a prior Ninth Circuit case).

The dissent's primary argument is that interpreting the statute to impose personal liability for estate taxes on persons receiving estate property after the decedent's death results in an illogical taxing system because the value of the property received years later may be less than the estate tax imposed based on the date of death value of that property.

(1) **Prior Case Law.** Prior cases interpreting §6324(a)(2) and its predecessors have concluded that the statute applies only to persons who have or receive property *on the date of the decedent's death* that is included in the gross estate (citing *Englert v. Commissioner* (1959), *Garrett v. Commissioner* (1994), and *United States v. Johnson* (D. Utah 2013)). Section 6324(a)(2) was amended in 1966 (after *Englert* and *Garrett* were decided), and the failure to change the syntax of

the relevant clause "indicates that Congress intended to keep the then-current judicial interpretation" (citing *Lorillard v. Pons*, 434 U.S. 575, 580 (1978) ("Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change")).

The dissent emphasizes that the interpretation adopted by the majority is the **"first time"** a court has reached that result.

(2) **Criticism of Majority's Reliance on Technical Grammatical Rules to Reach Illogical Result.** The dissent decries the majority's interpretation that reaches an illogical result based on "the lack of a comma" and an interpretive presumption based on the grammatical rule against misplaced modifiers.

(3) **Criticism of Majority's Response to "Illogical Results" Argument Because They Are Unlikely to Occur.** The majority responds to the "illogical results" argument by saying they are unlikely to occur for various reasons. One reason is that the beneficiary could disclaim and therefore avoid having a personal liability that exceeds the value of property when it is received from the estate. But the dissent points out that disclaimers generally must occur within nine months of the decedent's death, and at that point a beneficiary would have no way to know that the property would decline in value so precipitously before distribution that the beneficiary's personal liability for estate taxes would exceed the value received.

The dissent is particularly bothered with the majority's reliance on the government's "avowals" that it would not assert personal liability against a beneficiary for more than the value received by the beneficiary at the time of distribution. First, it noted the government's "avowals in its briefing and at oral argument … is merely a description of how the government has argued this case. It does not represent the government's interpretation of §6324(a)(2) or any promise regarding its future actions." Judicial estoppel is not applicable for various reasons. Furthermore, even if the government had purported to apply an interpretation that liability could not exceed the amount received, "such interpretation would still not be binding in future cases," and the government could change its position. Even if the government has not historically imposed personal liability that exceeded the value of property received, that "indicates only that the government has managed up until now to use special liens or surety bonds to secure its interest, but does not establish that the government's interpretation of § 6324(a)(2) is reasonable."

f. **More Detailed Discussion.** For a more detailed discussion of the analysis by the majority and dissenting opinions, see Item 26.d-e of Estate Planning Current Developments and Hot Topics (December 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

g. **Request for Rehearing Denied.** Taxpayers filed petitions for a rehearing en banc by the entire Ninth Circuit panel of judges, but that petition was denied July 25, 2023.

h. **Petition for Certiorari.** A petition for certiorari was filed with the U.S. Supreme Court (No. 23-436) on October 23, 2023, and the government filed its brief in opposition on January 29, 2024. Arguments in the petition include the following.

(1) **Intolerable Conflict With Prior Cases.** The opinion creates an intolerable conflict regarding the scope of personal liability under §6324(a)(2) with the Tax Court and every federal court that has considered the issue (citing *Englert v. Commissioner*, 32 T.C. 1008, 1015 (1959), *acq*. 1960 WL 62561 (Dec. 31, 1960); *Garrett v. Commissioner*. Memo. 1994-70; and *United States v. Johnson*, 2013 U.S. Dist. LEXIS 106671, 2013 WL 3924087, 112 AFTR 2d 2013-5474 (D. Utah 2013)).

(2) **Misapplies Rules of Construction.** The opinion misapplies the last antecedent rule of statutory construction and the rule of taxpayer lenity.

(3) **Conflicts With Sound Public Policy.**

(a) **Attempts to Amend §6324(a)(2) by Judicial Fiat.** The opinion attempts to resolve the practical problem of the possible overly broad potential personal liability resulting from its

interpretation of the persons to whom the statute applies by limiting personal liability to the value of property after the date of death at the time of becoming a trustee or receiving property as a beneficiary, contrary to the explicit terms of the statute.

> Recognizing that its novel interpretation of the scope of § 6324(a)(2) could impose substantial and unanticipated personal liability on recipients of estate property, the Ninth Circuit sought to limit those consequences by announcing that personal liability will be "capped at the value of estate property in the living trust at the time of Allen Paulson's death, and each defendants' liability cannot exceed the value of the property at the time that they received or had it as trustees." Pet. App. 49a. The Ninth Circuit decision created this new cap on personal liability for estate taxes out of whole cloth. It cites no authority—no statutory language, no tax regulation, no case law, no treatise—to support this extraordinary exercise in judicial law-making. This overreaching is contrary to this Court's precedent. *See, e.g., Griffin v. Oceanic Contractors*, 458 U.S. 564, 576 (1982); *Crooks v. Harrelson*, 282 U.S. 55, 60 (1930). If Congress believed that the Tax Court and other federal courts' interpretation of § 6324(a)(2) is incorrect or produces unacceptable results, it could amend the statute at any time, as it has on several occasions in the past.

(b) **Conflicts With Application of Judicial Estoppel.** The opinion conflicts with binding precedent as to the application of the doctrine of judicial estoppel against the government.

> The premise for the Ninth Circuit's creation of a new cap on personal liability for estate taxes under § 6324(a) (2) is its belief that the Government allegedly promised in its briefing and at oral argument that "estate tax liability cannot exceed the value of property received," and that it will not pursue recipients in this case for "more than the value of the property that the taxpayer received." Pet. App. 38a. According to the Ninth Circuit, application of the "doctrine of judicial estoppel" will safeguard against any unfair application while imposing personal liability. *Id.* at 38a-42a. It will also bind the Government to that limitation on recovery of unpaid estate taxes in future cases.
>
> …
>
> Nevertheless, the Ninth Circuit's decision stands as support for the erroneous proposition that the United States Government can be bound to its purported concession in its brief in future actions. This proposition raises serious constitutional concerns based on separation of powers. …
>
> Moreover, if the Ninth Circuit decision stands, the Government would be invited to engage in creative brief writing and attempt to use this new "doctrine strategically to achieve results Congress intended to prevent, thus delivering lawmaking power to the executive." *Marine Shale Processors*, 81 F.3d at 1348. These conflicts with sound public policy need to be resolved to ensure uniform national enforcement of the tax laws.

The National Taxpayers Union Foundation filed an amicus brief on December 19, 2023, arguing that the statute is ambiguous and should be construed in favor of taxpayers. The government filed its brief on January 29, 2024, largely reiterating the reasoning in the court of appeals opinion (including a detailed analysis distinguishing *Englert v. Commissioner*, a prior case interpreting the predecessor to §6324(a)(2) to apply it only to property received or held on the date of death) and also arguing that the case is a poor vehicle for resolving the underlying issues because it is an interlocutory appeal rather than an appeal from a final ruling.

The Supreme Court denied the petition for writ of certiorari on March 4, 2024.

i. **Criticism of *Paulson*.** The *Paulson* opinion has been roundly criticized by some commentators. Some of the arguments in the Cummings Article are summarized below.

(1) **Overview.**

> This article will focus on a circuit court decision for the IRS in a collections case, *Paulson*, involving a legal issue of statutory interpretation that should have been resolved long ago, and in fact was. Somehow *Paulson* was decided the other way, the wrong way, against the taxpayer.
>
> On first reading the circuit opinion, you might agree with it, if you know nothing about the history of the rules and don't think about their purpose. But on further analysis, you can see how the taxpayer probably is right; the district court judge and a dissenter thought so.

Cummings Article at section I.A.

(2) ***Paulson's* Statutory Construction.** The *Paulson* court looked to the "natural reading" of the statute based on punctuation.

> Although the circuit opinion is long, it was over after the judges fixed on the comma separating "receives" from "has." That meant that "on the date of the decedent's death" modified only "has" and not "receives."
>
> Undoubtedly commas can matter. But they should not be controlling, and the Supreme Court has never said they always are.

Id. at section V.A.

(3) **Analysis Should Look Beyond Formalistic Construction to Legislative Intent.**

> The 2-1 circuit opinion reversed the trial court primarily by citing that book on statutory interpretation and hewing closely to formalistic rules rather than search for congressional intent…. At bottom the circuit decision was made when the majority saw that "receives" was on the other side of the comma from "or has on the date of the decedent's death" in section 6324(a)(2) (dating to 1942 and never before interpreted that way by published IRS guidance or a court opinion).
>
> …
>
> The [government's] brief returned repeatedly to the argument that the old cases failed the Supreme Court's contemporary statutory interpretation process, under which courts begin with the statutory text and only look beyond the text when it is ambiguous….It never considered what Congress was trying to do with the section or the problem of a beneficiary being held to a death date liability when it had no right to the death date value.
>
> … **Why would a court reason that way?**
>
> This is the "you broke it, you fix it" approach to statutory interpretation by judges. It gives the appearance of the court acting like Pontius Pilate and washing its hands of the problem. But it is actually washing its hands of the historic judicial task of figuring out what the legislature intended but maybe imperfectly said. Because a court can choose to disregard an interpretive canon or claim it is overcome in rare cases, this approach to statutory interpretation actually invests in full judicial power to go with or against legislative intent, as it suits the judge, while appearing to be impartial.

Id. at section IV.B.1-2.

(4) **Legislative Intent – Personal Liability Regime for Estate Tax.** Section 6901 imposes no personal liability for estate taxes; if the transferee is personally liable under state law (under fraudulent transfer principles), §6901 provides a process for the IRS to collect tax. No provision in the Code imposes personal liability on beneficiaries of assets from the probate estate; instead, the executor is personally liable for estate tax, including tax on non-probate property that does not pass through the executor's hands. §2002 (requires executor to file the estate tax return, who can thus be assessed the tax as the named taxpayer); *see* Cummings Article at section III.A.

Section 6324 imposes personal liability on a beneficiary or fiduciary "who receives, or has on the date of the decedent's death, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property …." Is this interpreted to include beneficiaries or fiduciaries who *receive* non-probate property *after the date of death*? That would impose personal liability for estate taxes on beneficiaries of non-probate property, whereas beneficiaries of probate assets (includable in the gross estate under §2033) have no personal liability for estate taxes. That would make no sense.

> That seems pretty straightforward, and the intent of Congress is obvious: to hold directly responsible for the death date value of gross estate property the people who held or got it on the death date (including persons having a right to immediate possession of the property on that date). Obviously a very common case is property passing outside the probate estate in various ways, including most commonly under an *inter vivos* trust to the trust beneficiaries who did not receive a distribution until after the date of death. Why would Congress except them from this regime of personal liability?
>
> Well, there is one obvious reason: Congress also excepted the beneficiaries of the gross estate. [Section 6324(a)(2)] does not apply to probate estate heirs. And no other section makes them personally liable. None of the opinions discussed that fact.

Cummings Article at section III.A (citations omitted).

This regime still leaves the Treasury protected. The executor is personally liable for estate taxes on probate and non-probate property, and the trustee at the date of death of an inter vivos trust is personally liable for the estate tax on the trust assets. *See id.*

(5) **Prior Cases Regarding "Receives … On the Date of the Decedent's Death" Construction.** Four prior cases have held (or suggested based on related holdings for predecessor statutes) that §6324(a)(2) should not apply to beneficiaries or fiduciaries who receive non-probate assets after the date of death.

United States v. Johnson was cited by the *Paulson* trial court. *United States v. Johnson*, 112 AFTR 2d 2013-5474 (D. Utah July 29, 2013) ("in order for a person to be a transferee under section 6324(a)(2), the person must have or receive property from the gross estate immediately upon the date of decedent's death rather than at some point thereafter"), *subsequent determination that §6324(a)(2) does not apply to funded revocable trusts*, 224 F. Supp. 3d 1220, 118 AFTR 2d 2016-6781 (D. Utah Dec. 1, 2016), *subsequent award of attorney fees because government's position had not been reasonable*, 121 AFTR 2d 2018-341 (D. Utah Jan. 8, 2018), *rev'd as to statute of limitations and attorney's fees*, 920 F.3d 639 (10th Cir. 2019, cert denied, 140 S. Ct. (2019). It held that to be a "transferee" having personal liability for estate tax under §6324(a)(2) the person "must have or receive property from the gross estate immediately upon the date of decedent's death rather than at some point thereafter." 112 AFTR 2d 2013-5474, at 5478. That case reasoned in part that statutory ambiguities should be resolved in favor of the taxpayer, but the Cummings Article observes that "there is no pro-taxpayer presumption for ambiguous sections." Cummings Article at section III.B.1.

Johnson relied primarily on a 1959 Tax Court opinion, *Englert v. Commissioner*, which was also cited in *Paulson*. *Englert v. Commissioner*, 32 T.C. 1008 (1959), *acq*,1960-2 C.B. 4, 9 (estate tax decision). *Englert* involved a predecessor statute to §6324(a)(2) under the 1939 Code, as amended in 1942. *Englert* concluded that "because the trust beneficiary did not receive or hold the trust property on the date of death, the beneficiary was not liable — only the *inter vivos* trustee was liable because the trustee held the property at death." Cummings Article at section III.B.1.

Equitable Life Assurance Society v. Commissioner, 19 T.C. 264 (1952), was cited in the *Englert* opinion. *Equitable Life* held that a life insurance company that held life insurance proceeds on the date of death was not a transferee for purposes of the predecessor to §6324(a)(2).

Higley v. Commissioner, 69 F.2d 160, 13 AFTR 663 (8th Cir. 1934), was not cited by *Paulson* in its discussion of the "receives … on the date of the decedent's death" issue, but it was cited in its discussion of whether "beneficiary" in §6324(a)(2) refers only to life insurance beneficiary (or annuity beneficiaries). *Higley* concluded that it is "so clear" the term "beneficiary" in a predecessor statute does not include trust beneficiaries. The Cummings Article views *Higley* as the "best cite" because it "more solidly analyzed the purpose and intent of the overall collection scheme." Cummings Article at section III.B.2.

> Passing from consideration of this section alone to *consideration of it as a part of the general scheme of collecting this estate tax*, the position of petitioner is further strengthened. Throughout this chapter (Estate Taxes) runs the clear plan as to collection. The prime reliance is the property subject to the tax. Upon this a lien for the taxes is placed. As further assurance, a *personal liability is placed upon those who are in position to dispose of the property and possibly delay or defeat collection*. Upon them is placed a strong personal incentive to see that the tax is properly and promptly paid. This burden is placed only upon those (executors, administrators, fiduciaries, transferees, trustees, and insurance beneficiaries) who have such legal title, control, and possession as would afford opportunity to dispose of the property primarily liable for the payment of the tax. *A trust beneficiary may or may not occupy such a position, dependent upon the terms of the trust, but all opportunity for him to take advantage thereof is anticipated and guarded against by placing upon the trustee a personal liability and by attaching the lien to the* trust property. Although Congress has legislated repeatedly in this matter, it has in no instance used language clearly providing personal liability of a cestui que trust.

12 AFTR 663, at 666 (emphasis added in Cummings Article).

Higley was subsequently characterized by the Supreme Court as holding that "the personal liability of transferees did not extend to the beneficiaries under a trust." *Allen v. Trust Co.*, 326 U.S. 630, at n.5 (1946).

The Cummings Article points out several times that the IRS has never filed a non-acquiescence in any of these cases. Furthermore, the IRS was aware of the two older cases when it wrote regulations in 1954 regarding §6324(a)(2) and it could have taken a position in regulations clearly opposing the position taken by these cases; it did not do so. Cummings Article at section III.C.2.

(6) **Supreme Court Statutory Construction Cases Involving Commas.** The Cummings Article cites a large number of U.S. Supreme Court statutory construction cases involving commas.

> Throughout its history the Supreme Court has been willing to disregard commas and other punctuation and to insert commas, to reach the intent of Congress. In fact, far more Supreme Court opinions have disregarded commas like the one at issue in *Paulson* than have given commas such a prominent role. And sometimes the Supreme Court has added a comma that did not exist in the statute.

Id., at section V.B.1.

j. **Observations.**

(1) **FIRST CASE to Apply Personal Liability to Trustees or Trust Beneficiaries Who Are Appointed or Receive Distributions Only After Decedent's Death.** This case is notable because it is the first case (and at the federal court of appeals level, no less) to hold that §6324(a)(2) imposes personal liability on persons who are appointed co-trustees after the date of death or on trust beneficiaries who receive property after the decedent's death.

Prior cases (going back over 60 years) applied personal liability for estate taxes under §6324(a)(2) or its predecessors only to persons who were or became trustee at the date of the decedent's death or beneficiaries who have or receive property at the date of death. The first such case was *Englert v. Commissioner*, 37 T.C. 1008 (1959) (construing the predecessor of §6324(a)(2)). The most recent case reaching that same position is the unpublished district court opinion, *United States v. Johnson*, 2013 WL 3924087 (D. Utah July 29, 2013):

> Because section 6324(a)(2) may be interpreted in multiple ways, it is ambiguous and must be interpreted in favor of the Heirs. The court concludes that in order for a person to be a transferee under section 6324(a)(2), the person must have or receive property from the gross estate immediately upon the date of decedent's death rather than at some point thereafter.

(2) **Successor Trustees Should be Wary Before Accepting Office If Estate Tax Remains Unpaid.** Successor trustees of a decedent's revocable trust (or other trust that is included in the decedent's gross estate), who may be appointed years after the decedent's death, must be wary about whether the value of assets remaining in the trust when the trustee accepts appointment is less than the unpaid estate tax liability of the estate. By accepting appointment, the successor trustee may become personally liable for those estate taxes (in the Ninth Circuit or in other circuits that may adopt the position taken in *Paulson*).

The majority opinion in *Paulson* responded to this potential concern of successor trustees by observing that "trustees serve only if they are 'willing.'" *Paulson*, 131 AFTR 2d 2023-1743 at n.38.

(3) **Trust Distributions May Impact Beneficiaries' Status with Creditors.** If trust distributions from revocable trusts are made before all estate taxes have been paid, Steve Gorin (St. Louis) points out that the beneficiaries have a contingent liability that perhaps should be reflected on balance sheets and to creditors. That contingent liability exists until estate taxes are paid or until the statute of limitations on collections under §6502 have run. Beneficiaries may wish to avoid that complexity with creditors and banks by requesting that trust distributions be delayed until all estate taxes are paid.

(4) **Time Period of Potential Personal Liability.** Persons who have personal liability for estate taxes under §6324(a)(2) may have that liability hanging for a long period of time. Section 6324(a)(2) has no time limits specified, so the general collection provisions of §6501 and §6502 control. Section 6502 requires that an action to collect tax must be commenced within 10 years after the assessment of the tax, which must occur within three years after the estate tax return is filed, §6501(a), or within six years if items are omitted from the gross estate exceeding 25% of the

gross estate stated on the return, §6501(e)(2). However, the 10-year period after assessment can be suspended (for example, during a court proceeding, §6503(a)(1)), or extended (for example, during the period of an extension of payment under §6161 or during a deferral period under §6166, §6503(d)). (Similarly, the three-year period for assessment of estate tax is suspended during any Tax Court proceeding or any extension period for the payment of tax under §6161(a)(2), §6161(b)(2), §6163, or §6166. §6503(a)(1); §6503(d).) Accordingly, the collection action could be brought about 13 years after the decedent's death in a normal case and within about 25 years after the decedent's death if estate taxes are extended under §6166.

(5) **Potential Personal Liability Exceeding the Value of Property Received.** The dissent was quite concerned with interpreting the statute in a way that leads to the illogical result of a trustee or trust beneficiary who may have personal liability for estate taxes that exceeds the value of property when received by the trustee or beneficiary because the trustee or beneficiary is personally liable for estate tax up to the value on the date of death (or alternate valuation date) of property received by the trustee or beneficiary. The court recognized that there is no statute (under its interpretation of §6324(a)(2)) or cases that would prevent that possible result. The government made "avowals" in its brief and oral argument that personal liability is limited to the value received, but as the dissent points out, the government did not make promises that it would never take that position in future cases.

Despite the lack of authority for that limitation on personal liability, the Ninth Circuit's conclusion imposes a cap on each person's personal liability of "the value of the estate property at the time of decedent's death, or the value of that property at the time they received it."

The majority opinion reasoned that its construction of §6324(a)(2) to apply to persons who are appointed as trustees or receive trust property after the decedent's death is not illogical despite the possibility that the estate tax could exceed the value of property when received in part because the IRS "avowed" it would not take that position. However, the IRS has taken positions contrary to even published (and not withdrawn) Revenue Rulings in later cases. *See*, *e.g.*, *Estate of Hoensheid v. Commissioner,* T.C. Memo. 2023-34 (despite the court's attempt to distinguish Rev. Rul. 78-197 and *Rauenhorst v. Commissioner*, 119 T.C. 157 (1993)). The IRS in this same case (i.e., *Paulson*) took a position seemingly contrary to Rev. Rul.75-553, and the district court accepted the IRS's position. Similarly, the IRS took a position contrary to Rev. Rul. 75-553 in *United States v. Johnson*, 224 F. Supp. 3d 1220, 118 AFTR 2d 2016-6781 (D. Utah 2016), as well as in this case. See Item 27.j(7)(c) below.

Even if the personal liability exists only up to the value received by the beneficiary, the beneficiary must be careful to realize that there is potential personal liability for unpaid estate taxes up to that amount even if the value of the property received later declines in value.

(6) **IRS May Proceed Against Any Beneficiary or Trustee.** Within the limits applicable to any particular trustee or beneficiary, the IRS may proceed against any one or more of them to collect unpaid estate taxes. The person or persons tagged with having to pay the estate taxes could try to proceed against other estate beneficiaries in accordance with applicable apportionment provisions in the governing instruments or under state law.

(7) **Coordination With Other Personal Liability Statutory Provisions; Non-Probate Property Limitation in §6324(a)(2).** The IRS has a special estate tax lien for 10 years on estate property for the payment of estate taxes, §6324(a)(1). (The dissent discusses in its Section I.A the automatic estate tax lien and ways the government can protect itself during a §6166 deferral period that could last longer than the 10 years of the estate tax lien.)

If the government does not avail itself of those lien remedies, it can impose personal liability on certain persons. The government can impose personal liability on executors who make distributions during or causing insolvency. 31 U.S.C. §3713. It can also impose personal liability on "transferees" under §6901 and on six categories of persons identified in §6324(a)(2) regarding non-probate property. Certain limitations apply to personal liability under §6901, and the government can choose to assert personal liability under §6324(a)(2), for example if some of the

limitations under §6901 would prevent the government from collecting tax under that section. For an excellent discussion of transferee liability under §6324(a)(2) as well as under §6901, see Scott St. Amand, *The Intersection of Estate Tax Deferral, Liens, and Transferee Liability, Part II: The Complex Consequences of Deferral of Estate Tax Under §6166*, 48 TAX MGMT. EST., GIFTS & TRSTS. J. No. 3 (May 11, 2023).

(a) **Section 6901 Limitations.** There are significant limitations on personal liability of transferees under §6901 that do not apply to §6324(a)(2).

Time Limitation on Assessment. Section 6901(c) provides that the period of limitations for assessment of transferee liability against an initial transferee is one year after the expiration of the period of limitation for assessment against the transferor. The IRS generally must assess tax against the estate within three years of the filing of the estate tax return (§6501(a)), so §6901(c) generally requires assessment against the transferee within four years after the return was filed. However, the three-year period for assessment of estate tax is suspended during any Tax Court proceeding or any extension period for the payment of tax under §6161(a)(2), §6161(b)(2), §6163, or §6166. §6503(a)(1); §6503(d).

Limit on Amount of Liability. For transferee liability under §6901, federal courts have generally held that the transferee's liability is limited to the value of the transferred assets on the date of transfer. *E.g., Commissioner v. Henderson's Estate*, 147 F.2d 619 (5th Cir. 1945). As discussed in *Paulson*, the personal liability under §6324(a)(2) is not clearly limited to the value received at the time of distribution. It is clear that interest on unpaid estate tax is subject to the transferee liability rules. However, the cases have not been consistent with respect to whether the limit on liability to the value of property at the time of the decedent's death applies to interest as well as the unpaid principal of the tax itself.

State Law Insolvency Analysis (But Not Required for Estate and Gift Tax Liability Under §6324(a)(2)). Section 6901 does not impose personal liability on a transferee. Generally, the IRS must establish a transferee's liability under state law (typically under "fraudulent transfer" principles if the transferor was insolvent at the time of the transfer or was rendered insolvent by the transfer); §6901 provides a remedy or procedure to be used by the IRS as a means of enforcing the liability. However, that is not the case for estate and gift tax if personal liability can be established under §6324(a)(2) (estate tax) or §6324(b) (gift tax). *See Poinier v. Commissioner*, 858 F.2d 917 (3d Cir. 1988), *cert denied*, 490 U.S. 1019 (1989) (insolvency of transferor was not a prerequisite for establishing transferee liability for unpaid gift tax). Personal liability under those statutes may be enforced against a transferee under §6901.

(b) **Section 6324(a)(2) Personal Liability is Not Subject to Strict Four-Year Limitations Period.** Even if the IRS fails to assess a tax deficiency against beneficiaries within the general four-year period that would be allowed under §6901(c)(1) (keeping in mind that the assessment period is suspended during a Tax Court proceeding or when the tax is deferred under §§6161, §6163, or §6166), a transferee may nevertheless be liable for transfer taxes in some situations in which §6324(a)(2) applies. Various cases have reasoned that §6901(c) and §6324(a)(2) are "cumulative and alternative — not exclusive or mandatory." *E.g., U.S. v. Kulhanek,* 106 AFTR 2d 2010-7263 (W.D. Pa. 2010) (collection action against transferees 17 years after date of death); *Estate of Mangiardi v. Commissioner*, T.C. Memo. 2011-24, *aff'd in unpublished opinion*, 108 AFTR 2d 2011-6776 (11th Cir. 2011) (collection against IRA beneficiary commenced eight years after IRA owner's death with no prior assessment against the beneficiary). Therefore, the IRS may proceed against a transferee under §6324(a)(2) even if an assessment is not made against the transferee within four years as generally required under the §6901(c) alternative.

(c) **Section 6324(a)(2) Applies Only to Recipients of Non-Probate Property; Applicability to Funded Revocable Trusts; *Paulson, Johnson*.** A significant limitation of personal liability under §6324(a)(2) is that it applies only to recipients of assets included in the decedent's gross estate under §§2034-2042. Are the assets in a funded revocable trust includable in the

gross estate under §2036 or §2038 or merely under §2033? If the trust assets are included only under §2033, then §6324(a)(2) would not apply.

i. ***Paulson.*** The *Paulson* Ninth Circuit opinion does not address that issue, but the district court determined that the revocable trust assets were includable under §2038 and not §2033, so the trustee was therefore subject to personal liability for the estate tax §6324(a)(2) (despite a published Revenue Ruling to the contrary which the court did not discuss or even cite). 331 F. Supp. 3d 1066, 122 AFTR 2d 2018-5808 (S.D. Calif. 2018). The district court's only analysis of the §2033 vs. §2038 issue quotes from statements in *Estate of Tully v. United States*, 528 F.2d 1041 (Ct. Cl. 1976), that §2038 "taxes property which an individual has given away while retaining enough 'strings' to change or revoke the gift," while §2033 "is more general in its approach, and taxes property which has never really been given away at all." The district court concluded that the decedent's "ability to amend, revoke, or terminate the Living Trust triggers § 2038." Although the district court cited the 2018 district court case of *United States v. Johnson* (discussed below regarding another issue), it does not even mention that *United States v. Johnson* had a detailed analysis of the §2033 vs. §2038 issue for purposes of §6324(a)(2) and concluded that the revocable trust in that case was includable under §2033, so that §6324(a)(2) did not apply to the trustee of the trust. (The *Paulson* district court noted as to the other issue that *Johnson* was on appeal "and thus its conclusions are unpersuasive," but the appeal did not address the §2033 vs. §2038 issue for purposes of §6324(a)(2).) The *Paulson* district court case did not cite, let alone discuss, Rev. Rul. 75-553 that seemingly reached a contrary result (but addressed a revocable trust that passed to the decedent's estate at death rather than passing for the benefit of third parties).

ii. **Other Cases Applying §6324(a)(2) to Revocable Trusts.** Other cases have similarly stated that §6324(a)(2) applies to assets in revocable trusts without express analysis of the §2036-§2038 vs. §2033 issue. *E.g.*, *U.S. v. Allison, et al*, 587 F. Supp. 3d 1015, 129 AFTR 2d 2022-830 (E.D. Calif. 2022), *order adopting parties' stipulation for entry of judgment*, 131 AFTR 2d 2023-327 (E.D. Calif 2023); *Garrett v. Commissioner*, T.C. Memo. 1994-70 (beneficiary did not have discharge of indebtedness income from trustee's payment of estate taxes because the trustee, not the beneficiary, was personally liable for estate tax under §6324(a)(2)).

iii. ***United States v. Johnson.*** A prior district court case had held to the contrary, that the revocable trust assets were includable solely under §2033. *United States v. Johnson*, 224 F. Supp. 3d 1220, 118 AFTR 2d 2016-6781 (D. Utah 2016). *See* Rev. Rul. 75-553, 1975-2 C.B. 477 (trustee of revocable trust does not have personal liability for estate tax under §6324(a)(2) because revocable trust assets are includable only under §2033 and not §2036 or §2038 for a trust in which the decedent had retained all beneficial interests). *Johnson* referred to Technical Advice Memorandum 8940003, which addressed a transfer by "A" to a third party as trustee of a trust to be distributed as directed by A. The trust assets "were held solely for the benefit of A during A's lifetime and were payable to A's estate at A's death." The TAM concluded that the assets were includable in A's gross estate under §2033, not §2038.

The *Johnson* court also relied on Rev. Rul. 75-553, 1975-2 C.B. 477, to support the conclusion that §2033 applied, not §2038, for purposes of §6324(a)(2). In Rev. Rul. 75-553 the decedent transferred assets to a third party as trustee of a revocable trust that would be paid to the decedent's estate upon her death. Rev. Rul. 75-553 reasoned that §2036 - §2038

> do not become operative unless someone other than the decedent receives a beneficial interest in the transferred property. The transfer of property to a trustee acting as agent for the transferor, without a third party receiving any interest in the property, would not fall with the scope of section 2036, 2037, and 2038. In the instant case the trust corpus is payable to the decedent's estate and is property of the decedent within the meaning of section 2033 and is includible in the gross estate only under that section.

The court acknowledged that the trust in Rev. Rul 75-553 passed to the decedent's estate whereas the revocable trust in *Johnson* remained in trust for other beneficiaries. *Johnson* did not find that difference to be critical or even relevant.

> Additionally, the IRS was not focused on the fact that upon the Revenue Ruling decedent's death, trust assets were distributed to his estate, as opposed to a beneficiary or to a testamentary trust. It is true that here, Decedent's Trust arrangement meant that Trust assets avoided probate and allowed retention of control over a closely held business after Decedent's death. But Trust asset passage through probate—or any other after-death process or event—is not relevant to what beneficial ownership of the property the Decedent held during her lifetime. The court finds that these IRS interpretations of the Code and its regulations are reasonable and are entitled to substantial judicial deference.

224 F. Supp. 3d 1220, 118 AFTR 2d 2016-6781, at 6790-6791 (D. Utah 2016).

The *Johnson* court had originally found that §2036 and §2038 applied because "at the instant of death the beneficiaries in this property had a legally enforceable interest." *See id*. at 2016-6788. Upon reconsideration the court vacated that determination, reasoning that "Trust assets were never 'given away' such that Decedent lost the beneficial ownership of them during her lifetime, and thus that there was no transfer—incomplete or not—for purposes of sections 2036 and 2038 prior to Decedent's death." 224 F. Supp. 3d 1220, 118 AFTR 2d 2016-6781, at 6791 (D. Utah 2016). Therefore, the court concluded that the revocable trust assets were includable in the gross estate under §2033, which precluded the trustees from having personal liability for estate taxes under §6324(a)(2). This finding was strongly criticized by Professor Jeff Pennell. Jeffrey Pennell, *U.S. v. Johnson*, LEIMBERG EST. PL. NEWSLETTER #2497 (Jan. 10, 2017); *see also* Chuck Rubin, *U.S. v. Johnson: 3 Strikes Against the IRS in Attempting to Impose Fiduciary and Beneficiary Liability for Estate Taxes*, LEIMBERG EST. PL. NEWSLETTER #2496 (Jan. 10, 2017).

The district court subsequently awarded attorneys' fees and expert witness costs to the defendants. 121 AFTR 2d 2018-341 (D. Utah 2018). The court found that the government's position (regarding the §2033 vs. §2038 issue) was not substantially justified, **in part because of the failure to follow its own published guidance** in Rev. Rul. 75-553.

> While the defendants acknowledge that "the question of the proper code section of inclusion was a novel issue," …, the government's defense of this position merely restates their litigation position, without demonstrating why their position was reasonable.
>
> In particular, the government continues to assert that its "transfer" arguments were reasonable without addressing the court's conclusion that this position was inconsistent with the IRS statutory scheme and contradicted both IRS Technical Advice Memorandum 89-40-003 and IRS Revenue Ruling 75-553. *Johnson*, 224 F. Supp. 3d at 1232–34. 26 U.S.C. § 7430(c)(4)(B)(ii) provides that "the position of the United States shall be presumed not to be substantially justified if the Internal Revenue Service did not follow its applicable published guidance." Although the statute allows this presumption to be rebutted, the court concludes that the government's arguments fail to do so. Under the IRS statutory scheme, the only potentially applicable transfer sections (§§ 2036 and 2038) require beneficial ownership to have been given away while at the same time retaining some of the value of what has been given away. The government has not presented any factual or legal arguments that reasonably support a conclusion that Anna S. Smith divested herself of the beneficial ownership of her trust assets during her lifetime. Instead, its arguments directed the court's attention away from this critical fact. Because the government has not demonstrated that its position on trustee liability pursuant to 26 U.S.C. § 6324(a)(2) had a reasonable basis in fact or law, the defendants should be awarded attorney's fees for all aspects of their defense to these claims.

121 AFTR 2d 2018-341, at 344-45.

The Tenth Circuit heard an appeal, but only as to other issues. 920 F.3d 639, 123 AFTR 2d 2019-1272 (10th Cir. 2019). The government did not appeal as to whether §6324(a)(2) applied to funded revocable trusts.

iv. **Inconsistency With Rev. Rul. 75-553.** The IRS's published ruling position (Rev. Rul. 75-553) is that a revocable trust in which the decedent retained all beneficial interests and that passed to the decedent's estate at death is included in the gross estate under §2033, not §2036 or §2038, so §6324(a)(2) cannot apply. The IRS has claimed personal liability of trustees of funded revocable trusts under §6324(a)(2) seemingly in direct contravention of the holding of Rev. Rul. 75-553. What is the point of the IRS publishing its official position on issues in Revenue Rulings if taxpayers cannot rely on them? The Tax Court in *Rauenhorst v. Commissioner,* 119 T.C. 157 (1993), discussed in Item 26.b(8)(c) above, strongly criticized the IRS for taking positions contrary to published rulings.

> Respondent's counsel may not choose to litigate against the officially published rulings of the Commissioner without first withdrawing or modifying those rulings. The result of contrary action is capricious application of the law.

Arguably, however, the IRS is not taking inconsistent positions as to revocable trusts that are not paid to the decedent's estate following the decedent's death. The *Johnson* district court expressly rejected that distinction (and awarded litigation costs against the government in part of because of the IRS's failure to follow Rev. Rul. 75-553), but the IRS could legitimately take the position that such a distinction is appropriate. Professor Pennell believes that the distinction is very important. Jeffrey Pennell, *U.S. v. Johnson*, LEIMBERG EST. PL. NEWSLETTER #2497 (Jan. 10, 2017).

v. **Conclusion.** If future courts side with *Johnson* (which is consistent with Rev. Rul. 75-553), many of the concerns raised by *Paulson* would disappear (keeping in mind that §6324(a)(2) personal liability does not apply to probate property or property includable in the estate only under §2033). However, the concerns presumably would still be applicable to beneficiaries of IRAs or life insurance, trusts that are includable in the gross estate under §2035, or assets of limited partnerships or LLCs that are includable in the gross estate under §2036 or §2038.

28. Estate Tax Value of Shares Included Proceeds of Corporate-Owned Life Insurance to Fund Buy-Sell Agreement; Buy-Sell Agreement Did Not Meet §2703(b) Safe Harbor or Other Requirements to Fix Estate Tax Value*, Connelly v. United States,* 131 AFTR 2d 2023-1902 (8th Cir. June 2, 2023)*, aff'g* 128 AFTR 2d 2021-5955 (E.D. Mo. Sept. 2, 2021)*, cert. granted* (U.S. Dec. 13, 2023) (No. 23-146)

a. **Synopsis.** A buy-sell agreement required that a company purchase a decedent's shares of a corporation owned by two brothers. The pricing provision called for the parties to agree annually on the company value, and if an annual value had not been agreed on, the price would be determined by securing two or more appraisals (which would not consider control premiums or minority discounts). The company funded the agreement with life insurance policies on the two brothers' lives. The brothers never entered into any agreement about the company value, and on the death of the brother owning about 77% of the company, the estate and the company did not comply with the appraisal requirement in the agreement but agreed to pay the estate $3 million (using part of the $3.5 million of life insurance proceeds paid to the company) (as well as providing other benefits for the deceased brother's son).

The estate reported the shares at about $3 million, but the IRS assessed an additional $1 million of estate tax, maintaining the $3.5 million of life insurance proceeds should have been taken into consideration in setting the value. The estate paid the additional estate tax and sued for a refund. The parties stipulated that the value of the decedent's shares was $3.1 million if the life insurance proceeds were not considered, and the only issue was whether the life insurance proceeds should be considered in determining the value of the shares for estate tax purposes.

The district court determined that the buy-sell agreement did not fix the value of the shares. First, it did not satisfy the §2703(b) safe harbor; although the agreement met the bona fide business purpose test it failed to meet the device test (because the purchase price did not include the life insurance proceeds in determining the company's value, the *process* of selecting the redemption price

indicates the agreement was a testamentary device, and the agreement prohibited considering control premiums or minority discounts) and the comparability test (the estate "failed to provide any evidence of similar arrangements negotiated at arms' length"). Second, the agreement did not satisfy requirements recognized by various courts for buy-sell agreements to fix estate tax values: the agreement did not provide a fixed and determinable price; it was not binding at death (evidenced by the fact that its procedures were not followed); and it was a substitute for a testamentary disposition for less than full consideration. The Eighth Circuit agreed, reasoning more succinctly that the agreement did not set the estate tax value of the decedent's stock because the agreement did not establish a "fixed and determinable price." (Even if the pricing mechanism in the agreement had been followed, the court expressed reservations about whether those pricing mechanism would have been sufficient to establish a fixed and determinable price.)

Having determined that the agreement did not fix the estate tax value of the decedent's shares, the district court determined the value of the stock without regard to the agreement. The court concluded that the life insurance proceeds should be considered, disagreeing with the Eleventh Circuit's rationale in *Estate of Blount v. Commissioner* that the contractual obligation of a company to purchase a decedent's shares offsets the life insurance proceeds on the decedent's life paid to the company. A hypothetical willing buyer of a company would not factor the company redemption obligation into the value of the company because the buyer would merely be obligated to redeem the shares the buyer then held, and "the buyer would not consider the obligation to *himself* as a liability that lowers the value of the company to *him*." The taxpayer's request for a refund was denied. The Eighth Circuit affirmed, expanding on the district court's rejection of the rationale of *Estate of Blount*. The U.S. Supreme Court granted the taxpayer's petition for certiorari on December 13, 2023. *Connelly v. United States*., 70 F.4th 412, 131 AFTR 2d 2023-1902 (8th Cir. June 2, 2023), *aff'g* 128 AFTR 2d 2021-5955 (E.D. Mo. September 2, 2021), *petition for cert. filed* (U.S. Aug. 16, 2023), *writ granted* (U.S. December 13, 2023) (No. 23-146).

b. **Basic Facts.** Two brothers owned an operating business (Michael owned about 77% and Thomas owned about 23%). As is typical for family businesses, they entered into a buy-sell agreement regarding the purchase of shares at the death of a brother. The surviving brother had an option to purchase the shares, but if he chose not to do so, the company would be required to purchase the shares. The company purchased life insurance on each of the brothers' lives (including a $3.5 million policy on Michael's life) to fund the purchase agreement.

The purchase price would be determined under a two-step process. First, the brothers "shall, by mutual agreement, determine the agreed value per share by executing a new Certificate of Agreed Value" at the end of every year. Second, if they failed to do so, the "Appraised Value Per Share" would be determined by securing two or more appraisals.

The brothers never signed a single Certificate of Agreed Value. One brother died, Michael, who owned about 77% of the shares. The other brother, Thomas, chose not to purchase the shares, so the company purchased the shares, using $3 million of life insurance proceeds on Michael's life to fund the purchase price. The parties did not obtain appraisals, as required by the agreement, but Thomas and Michael's estate agreed (1) the estate would receive $3 million cash (from the life insurance proceeds), (2) Michael's son had a three-year option to purchase the company for $4,166,666, and (3) if Thomas sold the company within 10 years, Thomas and Michael's son would split evenly any gains from the sale.

The estate reported the value of Michael's shares at $3 million, but the IRS asserted that the value should also include the value of the $3.5 million of life insurance proceeds as a corporate asset and assessed over $1 million in additional taxes.

During the audit, the estate obtained an appraisal of the decedent's shares from an accounting firm. The appraisal reasoned that the buy-sell agreement created "an enforceable obligation to use the life-insurance proceeds to purchase" the decedent's stock and that, pursuant to the holding in *Estate of Blount v. Commissioner* (428 F.3d 1338 (11th Cir. 2005)), the life insurance proceeds should be excluded in determining the value of the company.

The estate paid the tax and sued for a refund of over $1 million. The estate and the IRS stipulated that if the life insurance proceeds should not be considered in determining the value of the shares, the value of the decedent's shares was $3.1 million. The only remaining issue was whether the life insurance proceeds received by the corporation as a result of the decedent's death should be considered in determining the value of the estate's shares.

c. **District Court Analysis Summary.** For a more detailed discussion of the district court analysis, see Item 39.c of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(1) **Estate Tax Value of the Shares Is Not Fixed Pursuant to the Buy-Sell Agreement.**

(a) **Section 2703(b) Safe Harbor Does Not Apply.** The buy-sell agreement did not satisfy the §2703(b) safe harbor. The agreement met the bona fide business purpose test, but it failed to meet the other two §2703(b) tests:

- It failed to meet the device test because the purchase price did not include the life insurance proceeds in determining the company's value, the *process* of selecting the redemption price indicates the agreement was a testamentary device, and the agreement prohibited considering control premiums or minority discounts; and
- It failed to meet the comparability test (the estate "failed to provide any evidence of similar arrangements negotiated at arms' length").

(b) **Additional Requirements Under Regulations and Case Law Not Satisfied.** Various cases have recognized several requirements for a buy-sell agreement to determine the price that will be recognized for estate tax purposes. These requirements are also embodied in Reg. §20.2031-2(h). The court summarized these requirements as follows:

> (1) the offering price must be fixed and determinable under the agreement; (2) the agreement must be legally binding on the parties both during life and after death; and (3) the restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for a testamentary disposition for less than full-and-adequate consideration.

The agreement did not satisfy these requirements. The agreement did not provide a fixed and determinable price; it was not binding at death (evidenced by the fact that its procedures were not followed); and it was a substitute for a testamentary disposition for less than full consideration.

(2) **Determination of Fair Market Value.** Because the buy-sell agreement did not control the value of the decedent's shares, the court determined the fair market value of the shares. Under the stipulation of the IRS and the estate, the only issue was whether the life insurance proceeds paid to the company at the decedent's death should be considered in valuing the decedent's shares.

The estate's primary argument was based on the Eleventh Circuit's opinion in *Estate of Blount*. The court in that case held that the fair market value of a closely-held corporation did not include life insurance proceeds used to redeem the shares of a deceased shareholder under a stock purchase agreement. The district court summarized the *Blount* holding and rationale:

> The Eleventh Circuit reasoned that the stock-purchase agreement created a contractual liability for the company, offsetting the life insurance proceeds. [Citation omitted] The Eleventh Circuit concluded that the insurance proceeds were "not the kind of ordinary nonoperating asset that should be included in the value of [the company] under the treasury regulations" because they were "offset dollar-for-dollar by [the company's] obligation to satisfy its contract with the decedent's estate."

The district court in *Connelly* disagreed with the Eleventh Circuit's analysis, preferring the reasoning of the Tax Court in *Estate of Blount*: a redemption obligation is not a "value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued."

The district court pointed out that a hypothetical willing buyer purchasing a company subject to a redemption obligation would not reduce the value of the company by the redemption obligation "because with the purchase of the entire company, the buyer would thereby acquire all of the

shares that would be redeemed under the redemption obligation." The buyer would merely be obligated to redeem the shares the buyer then held, and "the buyer would not consider the obligation to *himself* as a liability that lowers the value of the company to *him*." The district court observed that "construing a redemption obligation as a corporate liability only values [the company] post redemption (i.e., excluding Michael's shares), not the value of [the company] on the date of death (i.e. including Michael's shares)."

The district court concluded that the Eleventh Circuit's opinion in *Estate of Blount* is "demonstrably erroneous" and there are "cogent reasons for rejecting [it]." The $3 million in life insurance proceeds used to redeem Michael's shares must be taken into consideration in determining the fair value of the company and of the decedent's shares.

See also Estate of Cartwright v. Commissioner, 183 F.3d 1034 (9th Cir. 1999) (life insurance proceeds paid to deceased shareholder's estate was partly taxable income for uncompensated work in progress, not just for purchasing stock; life insurance proceeds were not "an asset of the firm for stock valuation purposes" because proceeds were "offset dollar-for-dollar" by the company's obligation to "pay out the entirety of the policy benefits" to the decedent's estate).

d. **Eighth Circuit Analysis.** The Eighth Circuit Court of Appeals decision addressed both (1) whether the estate tax value was established by the stock purchase agreement, and, if not, (2) whether the $3.0 million of life insurance proceeds used to redeem the estate's stock should be included in determining the value of the decedent's stock.

(1) **Value Not Established by Agreement.** The Eighth Circuit applied a much simpler analysis than the district court, determining that the §2703(b) exception was inapplicable because the agreement did not establish a "fixed and determinable price" given that the parties "ignored the agreement's pricing mechanisms." (Indeed, the determinable price must be binding during life as well as at death.)

The court also expressed reservations about what types of mechanisms for determining the purchase price would be sufficient. Even if the parties had followed the procedures in the agreement to determine the purchase price, the court stated (presumably in dictum) that the two pricing mechanisms in the stock purchase agreement would not have satisfied the "fixed and determinable price under the agreement" requirement. Those pricing alternatives were (1) the price per share set by "mutual agreement" in agreements executed annually by the shareholders, and if that was not done, (2) by appraisals of the fair market value. (Both are pricing mechanisms often found in buy-sell agreements.) The first alternative is "nothing more than price by 'mutual agreement'—essentially, an agreement to agree," and while the second alternative "seems to carry more objectivity, there is nothing in the stock-purchase agreement, aside from minor limitations on valuation factors, that fixes or prescribes a formula or measure for determining the price that the appraisers will reach." The court viewed a "determinable price" as one "arrived at" by "formula," "a fair, objective measure," or "calculation." Neither of the pricing mechanisms in the agreement were used (there were no annual agreements of value and no appraisals were obtained); the parties simply agreed on a purchase price after the decedent's death.

The court concluded that "neither price mechanism constituted a fixed or determinable price for valuation purposes. [Regulation citation omitted.] If anything, the appraisal mechanism calls for a rather ordinary fair-market-value analysis, which § 2031 and § 2703(a) essentially require anyway. Nothing therefore can be gleaned from the stock-purchase agreement."

(2) **Determination of Value Without Regard to Buy-Sell Agreement.** The parties stipulated the estate tax value of the stock, depending on whether the $3.0 million of life insurance proceeds that were used to redeem the decedent's stock is included as a corporate asset in valuing the decedent's stock. The parties had stipulated that the operational value of the company, exclusive of the life insurance proceeds, was $3.86 million and that the estate's 77.18% interest of the operational value was $2.982 million.

The Eighth Circuit observed that

> in valuing a closely held corporation, "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity." 26 C.F.R. § 20.2031-2(f)(2). This need to "take[ ] into account" life insurance proceeds appears again in a nearby regulation. 26 C.F.R. § 20.2042-1(c)(6).

The court stated that the decedent held no "incidents of ownership" in the policy, so the death proceeds were not includible directly in the gross estate under §2042, but they could be included indirectly in considering how the insurance proceeds impact the valuation of the decedent's stock. "Indeed, the $500,000 of proceeds *not* used to redeem shares and which simply went into [the company]'s coffers undisputedly increased [the company]'s value according to the principles in § 2031 and 26 C.F.R. § 20.2031-2(f)(2)."

As to the $3.0 million of insurance proceeds used to redeem the decedent's stock, the Eighth Circuit agreed with and expanded upon the district court's rejection of the rationale of *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005) that the insurance proceeds were offset by the company's obligation to use the proceeds to redeem the shares.

> The IRS has the better argument. *Blount*'s flaw lies in its premise. An obligation to redeem shares is not a liability in the ordinary business sense. See 6A Fletcher Cyclopedia of the Law of Corporations § 2859 (Sept. 2022 update) ("The redemption of stock is a reduction of surplus, not the satisfaction of a liability."). Treating it so "distorts the nature of the ownership interest represented by those shares." *See Est. of Blount v. Comm'r*, T.C. Memo 2004-116, 87 T.C.M. (CCH) 1303, 1319 (2004), *aff'd in part and rev'd in part*, 428 F.3d at 1338. Consider the willing buyer at the time of [the decedent]'s death. **To own [the company] outright, the buyer must obtain all its shares. At that point, he could then extinguish the stock-purchase agreement or redeem the shares *from himself*. This is just like moving money from one pocket to another. There is no liability to be considered—the buyer controls the life insurance proceeds.** A buyer of [the company] could therefore pay up to $6.86 million, having "taken into account" the life insurance proceeds, and extinguish or redeem as desired. See C.F.R. § 20.2031-2(f)(2). On the flip side, a hypothetical willing seller of [the company] holding all 500 shares would not accept only $3.86 million knowing that the company was about to receive $3 million in life insurance proceeds, even if those proceeds were intended to redeem a portion of the seller's own shares. To accept $3.86 million would be to ignore, instead of "take[ ] into account," the anticipated life insurance proceeds. See *id.*
>
> (Emphasis added).

The court added a simple example and concluded: "In sum, the brothers' arrangement had nothing to do with corporate liabilities. The proceeds were simply an asset that increased the shareholders' equity. A fair market value of Michael's shares must account for that reality."

e. **Supreme Court Will Review.** The U.S. Supreme Court granted the estate's petition for a writ of certiorari on December 13, 2023 (over the opposition of the Solicitor General). The Supreme Court takes a very small percentage of cases and rarely hears cases regarding estate tax matters. The Court's acceptance of *Connelly* is surprising. *See* Paul Hood & Ed Morrow, *Supreme Court Grants Writ of Certiorari in Connelly v. Internal Revenue Service*, LEIMBERG BUSINESS ENTITIES NEWSLETTER No. 286 (Dec. 18, 2023).

The petitioner's brief was filed January 24, 2024. The major arguments in the brief are summarized, with a few excerpts from the brief's summary.

(a) The willing-buyer/willing-seller test accounts for all relevant facts concerning the relevant property.

(b) The willing buyer and willing seller valuing a closely held corporation would disregard life-insurance proceeds used by the corporation to fulfill an offsetting obligation to redeem the insured's stock.

> Because the willing buyer and willing seller are informed and economically rational, they would take account not only of a company's anticipated assets but also its anticipated liabilities. And because a company's redemption obligation constitutes a binding contractual obligation, a willing buyer and willing seller would consider a redemption obligation to constitute a corporate liability, and take that liability into account when bargaining over the value of the company's stock. To the extent insurance proceeds are designated for a stock redemption, the willing seller and willing buyer would therefore view them as offset by the redemption obligation. Petitioner's Brief at 14.

(c) The proper valuation of a block of corporate shares does not include value available only to a purchaser of the entire company.

> The court of appeals, however, concluded that a prospective buyer of the estate's shares could capture the value of the life-insurance proceeds by purchasing not only the estate's shares, but all of Crown's shares, and then extinguishing the corporation's mandatory redemption obligation. That approach incorrectly imputes to a portion of Crown's stock a control premium that would be available only to an owner of the entire company. It is inconsistent with the willing-buyer/ willing-seller test to assume that a willing buyer of some stock would ultimately purchase and control additional stock. Petitioner's Brief at 15.

(d) Increasing the value of an estate's stock based on corporate insurance proceeds designated for a stock redemption would create negative practical consequences.

> The valuation approach proposed by the IRS and adopted by the court of appeals would lead to economically harmful and irrational consequences. Insurance proceeds designated for a mandatory stock redemption are a critical tool for allowing small businesses to preserve the closely held character of their companies. Treating those proceeds as a net asset for estate-tax purposes would badly hamper those efforts. In particular, the IRS's approach would force companies to purchase life insurance policies many times larger than the value of the stock they seek to redeem, in order to cover the spiraling costs of a prospective redemption. The IRS's approach would also disrupt decades-old settled understandings of tax law. And it would permit the IRS to collect an improper windfall, subjecting the same value to both estate tax and capital-gains tax despite congressional policy against such double taxation. Petitioner's Brief at 15-16.

An amicus brief filed by the Chamber of Commerce of the United States of America and National Federation of Independent Business Small Business Legal Center, Inc. supports the taxpayer's position, making the following major points.

I. Closely held companies play a vital role in the economy.

II. Redemption agreements and life insurance are critical, prudent planning tools that the decision below improperly threatens.

A. Redemption agreements paired with life insurance are a prudent solution to a pressing problem frequently faced by closely held companies.

B. The court of appeals and IRS distort the operation and object of redemption-plus-life insurance arrangements.

C. The IRS's and Eighth Circuit's position would imperil a vital planning tool.

III. The IRS's current interpretation is not entitled to deference because of its inconsistent positions and lack of reasoned explanation.

The brief discusses the IRS's shifting positions in the history of relevant cases, cited in chronological order *Newell v. Commissioner*, 66 F.2d 102 (7th Cir. 1933); *Estate of Huntsman v. Commissioner*, 66 T.C. 861, 872 (1976); *Estate of Cartwright v. Commissioner*, 183 F.3d 1034 (9th Cir. 1999); *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005).

Amicus briefs filed by several law professors support the government's position. An amicus brief filed by Adam Chodrow (Sandra Day O'Connor College of Law at Arizona State University) includes the following comments (among others).

I. Redemption obligations differ from other kinds of corporate obligations because they divide existing corporate assets among shareholders without reducing shareholder value. Offsetting life insurance proceeds—or other corporate assets—with a redemption obligation changes both corporate and shareholder value.

II. Fair market value redemptions have clear markers that distinguish them from below-market redemptions, and offsetting insurance proceeds—or other corporate assets—with a redemption agreement leads to absurd and illogical results that lack these markers.

> [I]f a redemption at fair market value occurs, (1) the value of a shareholder's interest after a redemption (whether in cash or retained shares) reflects his proportional interest in the value of the pre-redemption

corporation; (2) the aggregate post-redemption values held by the current and former shareholders equals the pre-redemption corporation's value; (3) the value of the remaining shareholders' interests remains unchanged, even as their percentage interest in the corporation increases; and (4) the corporation shrinks. Allowing taxpayers to offset insurance proceeds with a disregarded redemption obligation leads to a valuation and redemption that lacks all these markers…. [T]he shares' value would differ depending on whether they were being sold to a third party, retained by the decedent's heirs, or redeemed. That makes no sense.

…

At his death, Michael Connelly owned 77.18% of the company, while his brother Thomas owned 22.82%. J.A. 1. Thus, Michael's shares should have been worth about 77% of the corporation's total value, while Thomas's shares should have been worth about 23%. Michael's estate received $3 million for Michael's shares, which Petitioner asserts reflects their fair market value. D. Ct. Dkt. 53-2, at 14.16 The post-redemption corporation was worth $3.86 million. J.A. 102.

…

Offsetting the insurance proceeds with the disregarded redemption obligation leads to a valuation and redemption that lacks all these markers. First, if Petitioner's position is correct and the fair market value of Michael's shares was $3 million,17 Thomas's interest should be worth approximately $896,000. However, the post-redemption company was worth about $3.86 million. J.A. 102. This is 100% of the pre-redemption value Petitioner claims, strongly suggesting that Michael's shares were worth far more than the $3 million Michael's estate received.

Second, if one adds Michael's $3 million in cash to Thomas's $3.86 million interest in the post-redemption corporation, the total value of the corporation was $6.86 million, not the $3.86 million Petitioner claims. Moreover, Thomas's 23% interest in the pre-redemption corporation (now reflected in the post-redemption corporation's value) is worth more than Michael's 77% interest. That simply cannot be.

Third, Thomas's shares purportedly increased in value from about $896,000, pre-redemption, to $3.86 million, post-redemption. That cannot occur with a fair market redemption.

Finally, if one accepts Petitioner's $3.68 pre-redemption valuation, the corporation did not shrink after the redemption. Redemptions must shrink corporations because they allocate part of the pre-redemption value to the redeemed shareholder.

Amicus Brief at 15-17, 26-28.

III. The taxpayer's reasoning is not limited to insurance proceeds, significantly broadening the impact of its position and leading to additional irrational results. If redemption obligations are binding obligations, they must offset any and all corporate assets, not just those that were acquired to fund the redemption or that purportedly pass through the corporation.

Allowing redemption obligations to offset all corporate assets would significantly expand the impact of Petitioner's proposed rule. Moreover, it could result in a taxpayer being better off with a flawed effort to reduce the value of his shares for estate tax purposes than if he had succeeded. Returning to our corporation with $10 million in assets and a 60/40 split, imagine that the corporation enters into a redemption obligation to acquire A's shares for $4 million, despite the fact that they are worth $6 million. Further assume that the parties fail to meet Section 2703's requirements, such that the agreement is disregarded and we must determine the shares' fair market value. If the disregarded agreement nonetheless offsets corporate assets, then the corporation is worth only $6 million, and A's 60% is worth $3.6 million, less than the $4 million value that was disregarded. Congress (or the IRS) cannot have intended that a failed effort to lower the value of A's shares yields a better tax result for A than had the agreement been respected. Were the court to bless Petitioner's position, creating intentionally defective redemption obligations would become the next tax planning tool for closely held corporations.

Amicus Brief at 33.

Prof. Chodorow made some of these same arguments in an article eight years ago criticizing the *Blount* decision. Adam Chodorow, *Valuing Corporations for Estate Tax Purposes: A* Blount *Reappraisal*, 3 HASTINGS BUS. L.J. 20 (2006).

An amicus brief filed by Prof. Brant Hellwig (NYU School of Law) makes some of the same points and expands on them.

I. A redemption obligation is not properly regarded as a liability that reduces corporate net worth.

> [A]a redemption based on a corporate valuation determined [by treating the corporation's obligation to redeem stock as a value-reducing liability] operates to increase the value of equity held by continuing shareholders. That result alone raises a red flag. A redemption of one shareholder for fair market value should not affect the value of the stock held by continuing shareholders. Any enhancement in the value of the shares of the continuing shareholders indicates that the redemption price was below the true value of the redeemed stock.
>
> …
>
> Obligations on behalf of a corporation to pay salaries, operating expenses, contractual damages, or even claims registered in tort all constitute liabilities that reduce corporate net worth. A contractual agreement on behalf of a corporation to redeem the stock of a shareholder at fair market value, however, is a qualitatively different matter. No one would assert that a corporation's binding commitment to purchase property at fair market value operates to reduce corporate net worth. Rather, one asset on the balance sheet (cash) is simply replaced with a different asset (purchased property) having the same value. In a sense, a corporation's obligation to redeem its shares falls within this same broad framework. The corporation is simply purchasing its own shares for fair market value.
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> Amicus Brief at 3, 10-11.

II. Reducing a corporation's net worth on account of a binding redemption obligation would yield divergent estate tax consequences across economically similar transactions. The estate tax value of a decedent's stock would be less if the stock were redeemed pursuant to a binding agreement in effect at the shareholder's death than if (i) the stock were sold back to the corporation pursuant to an agreement negotiated after the decedent's death, (ii) the estate sold the stock to an existing shareholder under a cross-purchase agreement, or (iii) the estate distributed stock to the decedent's heirs.

> The difference in estate tax values assigned to the identical equity interest in a corporation across these alternative dispositions cannot be supported. Sanctioning these valuation discrepancies would create a clear estate tax advantage for disposing of interests in closely held businesses through pre-arranged redemptions. Owners of closely held businesses who prefer simply to pass their holdings to family members directly would face an effective estate tax toll for that choice.
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> Amicus Brief at 15.

III. Reducing the estate tax value of stock on account of a corporation's redemption obligation would jeopardize the estate tax base.

> A determination from this Court that a corporation's binding obligation to redeem a shareholder's equity interest at death operates to reduce the estate tax value of the redeemed shares would create a glaring opportunity to avoid federal estate taxation. Taxpayers would exploit the estate tax valuation flaw, transferring wealth to closely held business entities—whether corporations or partnerships—with binding redemption obligations for the estate tax savings alone. Considering the most extreme example of such planning, an individual could transfer wealth to a wholly owned corporation and enter into an agreement requiring the corporation to redeem the shareholder's stock at death (effecting a liquidation in that instance) for an amount equal to the value of the property then held by the corporation. If the redemption obligation were treated as a charge on the corporation's assets for purposes of valuing the decedent's shares, the estate tax value of the stock would be zero. In this manner, wealth transferred by reason of death could rather easily be removed from the reach of the federal estate tax.
>
> If a ruling in favor of petitioner somehow could be limited to the context of corporate-owned life insurance, the prospect of considerable estate tax avoidance remains. Individuals could capitalize closely held business entities to serve as wealth management vehicles, assigning minority interests to family members or other intended beneficiaries in the process. The entity then would invest a significant portion of those assets in life insurance on the principal owner's life, creating a pool of liquidity to fund the entity's obligation to redeem the principal owner's interest at death. If the insurance proceeds were disregarded in determining the net worth of the entity, the redemption transaction would effectively transfer value equal to the insurance proceeds (through enhancement of the continuing owners' equity interests) free of estate taxation. Individuals far beyond any notion of a small business owner could, and likely would, exploit that advantage.
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> Amicus Brief at 15-16.

Oral argument was held in the Supreme Court on March 27, 2024. Justices acknowledged the difficulty of the question presented to them (Justice Kavanaugh said "I find this case extremely difficult") and grilled both sides.

Both parties summarized the facts as whether the decedent's 77.18 percent of the company's stock should be valued as if the company is worth $3.86 million (the value of the company without the $3 million of life insurance proceeds used to redeem the stock) or $6.86 million (including such $3.0 million of life insurance proceeds). All parties acknowledged that the surviving brother ended up owning all the stock of the company having a value of $3.86 million.

Government counsel pointed out that the decedent's estate received $3 million in cash and the surviving brother ended up with $3.86 million in value, and the value of both those pieces together is $6.86 million, suggesting that the decedent's stock should have been valued at 77.18 percent of $6.86 million, or $5.13 million. Estate counsel observed that paying $5.13 million for the decedent's stock would require the company to sell assets because the $3.5 million of insurance proceeds would not have been sufficient to pay that amount. See Chandra Wallace, *Justices Grapple With Estate Tax Value of Closely Held Company*, TAX NOTES (March 28, 2024).

Justice Thomas observed that the $3 million of life insurance proceeds used to redeem the stock "has to go someplace. Does it go into the value of the remaining stocks? And if it is there, why isn't the appropriate valuation $6.86 million?" *Id.*

Justice Kagan focused on the fact that the surviving brother's value quadrupled after the redemption (going from 22.82% x $3.86 million, or $880,852, to $3.86 million, reflecting an increase of 4.38 times). She reasoned:

> It seems the fundamental problem with your approach is that Thomas's [the surviving brother's] asset has quadrupled in value. And it's quadrupled in value without him putting a single cent more into the company.…

She viewed that fact as "a tell that your way of calculating the thing is wrong." *See Id.*; John Wooley, *High Court Signals Doubt Over Estate Insurance Tax Treatment*, BLOOMBERG DAILY TAX REPORT (March 27, 2024). She summarized the government's position as follows.

> Your basic pitch is: [The company's obligation to redeem stock] is not any old liability. A redemption obligation is supposed to split the pie, so you come away with a smaller pie … because that's what redemption obligations do."

f. **Observations.**

(1) **Result Not Surprising, Though Inconsistent With Prior Circuit Level Case.** Given the many lapses in the implementation of the redemption transaction, the taxpayer's loss is not unexpected. Including the life insurance proceeds received by a company at the decedent's death in valuing the decedent's interest in the corporation for estate tax purposes is not surprising, but the Eighth Circuit Court of Appeals' opinion is very significant as a repudiation of the contrary holding by the Eleventh Circuit Court of Appeals in *Blount*.

The Eighth Circuit explained the "illogic" of excluding the life insurance proceeds by observing that the surviving shareholder's value would have increased from $7,720 per share (without including the life insurance proceeds) to $33,800 per share. The survivor's shares would have quadrupled in value "without any material change to the company." "This view of the world contradicts the estate's position that the proceeds were offset dollar-by-dollar by a 'liability.' A true offset would leave the value of Thomas's share undisturbed."

Carlyn McCaffrey (New York, New York) explains using a different example. Assume a company having an operational value of $10 million is owned equally by mom and daughter, and the company is obligated to purchase the shares from the estate of a deceased shareholder at 50% of the company's value. Assume the company owns a $5 million life insurance policy on mom's life to fund the purchase of her shares at her death. At mom's death, the company receives the $5 million of life insurance proceeds. If the life insurance proceeds are not taken into account in determining the value, mom's estate will be paid 50% of $10 million, or $5 million. On the other hand, if the company had accumulated $5 million of liquid assets to fund the buyout of mom's shares at her death, the company would be worth $15 million, and the purchase price would be $7.5 million. Under the estate's position, the company can fund the buy-sell agreement purchase by paying for a life insurance policy rather than by accumulating funds, and thereby decrease the

purchase price from $7.5 million to $5 million. Carlyn's reaction: "That sounds like nonsense, doesn't it?"

(2) **Buy-Sell Agreement With Life Insurance Funding.** One of the factors in determining whether to use a corporate purchase or a cross purchase arrangement in structuring a buy-sell agreement that will be funded with life insurance is that life insurance proceeds received by the company may be included in the estate tax value of the decedents' shares, resulting in escalating values of the shareholders' interests in the company. (If the purchase price is fully funded with life insurance, as each owner's interest is purchased at death using the life insurance proceeds the company value remains constant but the remaining owners have increasing percentage interests in the entity as each owner dies, which increases the value of their interests and requires more life insurance funding.) A pricing formula that does not include the full amount of insurance proceeds payable to the company is very suspect as failing to satisfy the §2703(b) safe harbor (as evidenced by the *Connelly* opinion).

The economic impact of not including insurance proceeds in valuing a decedent's shares is to produce a huge windfall to the surviving shareholders. They end up owning the company free of the decedent's shares without having to pay anything following the decedent's death.

The windfall to the surviving shareholders may be greatly reduced by including the amount of the insurance proceeds on the decedent stockholder's life in the value of the corporation. However, this approach will be circular and thus greatly increase the amount of insurance coverage needed in order to fund fully the buy-sell agreement. But including life insurance proceeds in determining the value of the company following a shareholder's death reflects the economic reality of the value of the company at that time. That the IRS maintains that the estate tax value of the decedent's shares following an insured shareholder's death should reflect that economic reality is not surprising.

(3) **Buy-Sell Agreement Structuring.** A very important issue in structuring a buy-sell agreement is whether an entity purchase or cross purchase arrangement will be used. For example, the *Connelly* agreement gave the surviving shareholders the first option to purchase a decedent's shares, but if that option was not exercised, the agreement required the corporation to buy the shares.

- Entity Purchase – the parties may feel more comfortable with the entity taking steps to fund the purchase agreement rather than relying on other owners to accumulate funds (or purchase life insurance) to fund a purchase obligation, but the funding in the entity (such as life insurance) may increase the value of the entity (as in *Connelly*); for a corporation, tax considerations include whether the redemption of stock by the corporation will be given sale or exchange vs. dividend treatment.
- Cross purchase – the parties must rely on the remaining owners to purchase their interests at death, funding will be outside the entity, not increasing the entity's value at the death of an owner, and a basis step up for the units purchased will be permitted; these advantages are quite significant; if an entity has multiple owners, one approach is to have the owners form a separate partnership to own a life insurance policy on each owner's life rather than having each owner purchase a life insurance policy on each other owner's life. *See* Private Letter Ruling 200747002 (LLC owned life insurance for funding of cross-purchase buy-sell agreement of S corporation, with all shareholders of the S corporation as members of the LLC).

(4) **"Fixed and Determinable Price in the Agreement" Dictum by Eighth Circuit Suggests That Many Buy-Sell Agreements Would Not Set the Estate Tax Value.** The Eighth Circuit held that a "fixed and determinable price" was not established under the stock purchase agreement, partly because the parties did not follow the pricing mechanisms set out in the agreement. Even if those procedures had been followed, however, the Eighth Circuit suggested (presumably in dictum) that would not have been sufficient to determine the estate tax value of the stock. That observation by the court is quite significant because the pricing procedures in the buy-sell

agreement in *Connelly* ((1) annual valuation agreements and (2) appraisal procedures) are often found in buy-sell agreements. A purchase under a binding agreement pursuant to those procedures might not be recognized as the value for estate tax purposes of the purchased interest under the reasoning of this dictum in *Connelly*.

(5) **Effect of Considering Life Insurance Proceeds in Determining Value.** If a buy-sell agreement does not effectively fix the estate tax value of the stock, the corporate insurance proceeds should be considered as a factor in determining the corporation's value, and the proceeds should not merely be added to the value of the corporation determined without regard to the proceeds. *See Estate of Huntsman*, 66 T.C. 861, 872-76 (1976), *acq*. 77-1 C.B. 1 ("determine fair market value … by giving 'consideration' to the insurance proceeds"); *Newell v. Commissioner,* 66 F.2d 102, 103-04 (7th Cir. 1933) (key shareholder's estate established that stock increase was offset by decrease in corporation's value caused by loss of key shareholder).

29. Transfer Planning With QTIP Trusts, *McDougall v. Commissioner,* CCA 202118008

a. ***McDougall v. Commissioner*, CCA 202118008.** Chief Counsel Advice 202118008 is an excellent illustration of the difficulty and complexity of planning with QTIP interests. The spouse-beneficiary ("Spouse") held a testamentary limited power of appointment. The Spouse, his two children ("Children") as remainder beneficiaries, and virtual representatives of the contingent remainder beneficiaries, entered into an agreement to have all the trust property (valued at $118 million) distributed to the Spouse. On the same day, the Spouse transferred the trust assets to trusts for the Children and their descendants, partly as a gift and partly as a sale in return for secured promissory notes. The CCA addressed various issues.

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

The three gift tax cases involving the Spouse and each of the two Children were consolidated for trial. *McDougall v. Commissioner*, Docket Nos. 2458-22, 2459-22, and 2460-22 (Petitions filed February 18, 2022, Judge Halpern). (The taxpayers are represented by John Porter, Keri Brown, and Tyler Murray.) The court is now considering motions for summary judgment filed by the various parties. *See* Erin McManus, *QTIP Trust Beneficiaries Say IRS is Triple-Dipping*, TAX NOTES (May 19, 2023).

Motions filed in the case reflect the values involved in the transactions. The value of the QTIP trust at the time of the commutation was about $117.6 million. The Notices of Deficiency asserted that the surviving husband made a gift of the remainder interest under §2519 equal to about $106.8 million and the remainder beneficiaries made gifts in an equal amount back to the surviving husband. The surviving husband's gift tax deficiency was about $47.7 million and the remainder beneficiary's gift tax deficiency was about $43.4 million, resulting in total gift tax deficiencies of over $80 million. And the husband was left owning promissory notes equal to the value of the QTIP assets that would be subject to transfer tax in the future.

The IRS made the arguments described above in CCA 202128008 and also argued, in the alternative, that the surviving husband's sale of substantially all of the QTIP assets that he received as a result of the nonjudicial agreement (NJA) in exchange for promissory notes resulted in a disposition of his qualifying income interest in the trust, thus triggering §2519.

The surviving husband's motion for summary judgment summarized the IRS's position as follows:

> Despite the fact that Bruce's [Bruce was the surviving husband] gross estate remained unchanged, Respondent issued notices of deficiency asserting that the termination of the Residuary Trust and the distribution of its assets to Bruce resulted in two simultaneous taxable gifts of the same assets. First, in his notice of deficiency to Bruce,

> Respondent asserts that there was a "deemed" gift by Bruce to Linda and Peter [the children of Bruce and his deceased wife who are the contingent remainder beneficiaries] equal to the value of the remainder interest in the Residuary Trust for which gift tax is due. Second, in nearly identical notices of deficiency issued to Linda and Peter, Respondent asserts that there were simultaneous gifts by Linda and Peter, collectively, back to Bruce, consisting of the same assets and in the same amount as Bruce's gift to them, for which Respondent claims gift tax from each of Linda and Peter is due. Finally, under Respondent's theory, there will be a third tax on the value of those assets when Bruce subsequently transfers the assets by gift or upon his death.

The surviving husband's responses in his motion for summary judgment to the IRS's arguments are summarized.

(1) The NJA, which resulted in the termination of the QTIP trust and distribution of its assets to the surviving husband, expressly invoked and followed the IRS's guidance for reciprocal gifts in Rev. Rul. 69-505, created offsetting reciprocal transfers of equal value, resulting in the surviving husband receiving the assets. The NJA expressly states that it (1) "results in a deemed gift, for federal gift tax purposes, of the remainder interest in the Trust assets from Bruce [the surviving husband] to Linda and Peter under Section 2519 of the Code," and (2) also results in a gift of the remainder interest in the trust from the remaindermen to the surviving husband. Those two gifts result "in a reciprocal gift transfer." "The simultaneous transfer of interests was part of an integrated transaction."

(2) Rev. Rul. 69-505 involved transfers by joint tenants to a trust. The ruling concluded that "[t]he transfers between the joint tenants are treated as a reciprocal exchange for consideration in money or money's worth…. Thus, neither is considered to have made a gift to the other to the extent that the transfers are of equal value."

(3) The QTIP regime conceptually creates a tax fiction in effect treating "the second spouse as owning the subject property outright, rather than owning merely a life or other terminable interest." *Estate of Sommers v. Commissioner*, 149 T.C. 209, 223-24 (2017). The NJA produced the same result as if the assts had been left outright to the husband rather than in the QTIP trust "and thus should have the same transfer tax consequences because the value of the assets included in [the surviving husband's] gross estate remained unchanged by the execution of the NJA," and the husband's sale of the assets in exchange for promissory notes left the value in his gross estate unchanged. In effect, the husband's acquisition of all the assets of the terminated QTIP trust as a result of the NJA left "the surviving spouse's real world **unchanged** from the 'tax fictional' world that evaporated when the QTIP terminated." (Emphasis in original)

(4) The taxpayer distinguished *Kite* because it would have resulted in a transfer without gift or estate tax because of the deferred private annuity coupled with a premature death if gifts had not occurred under §2519. In contrast, in *McDougall* no transaction occurred in which the children received assets of the trust in a manner that would result in no gift or estate tax upon the husband's transfer of the assets because the promissory notes are subject to transfer tax.

(5) The rationale of Rev. Rul. 98-8, 1998-7 I.R.B. 24, is consistent with the taxpayer's position. In Rev. Rul. 98-8, the surviving spouse's purchase of the remainder interest in the QTIP trust was treated as a gift to the remainder beneficiaries equal to the purchase price paid because the assets comprising the remainder interest were already included in the surviving spouse's gross estate. Under the QTIP regime, the remainder was already owned by the spouse (i.e., it was in the spouse's gross estate), so "nothing was acquired by the surviving spouse for the consideration paid and the surviving spouse's gross estate was diminished." That is not the result in the *McDougall* facts; the surviving husband's gross estate was not diminished.

(6) The position of the IRS results in triple taxation that is inconsistent with the structure and purposes of the QTIP rules.

> **In light of this, Respondent's position that would tax the same asset twice in the same day in a back-and-forth transfer and, for a third time, when the patriarch passes away (which could theoretically cause the triple transfer taxation of the property on the same day) is preposterous.** Bruce will be subject to estate tax on the value of the Residuary Trust received upon its termination, unless those assets are consumed or the object of a subsequent *inter vivos* taxable gift, which is the same circumstance that would have resulted had the Residuary Trust been left undisturbed. Perhaps the better analogy is that this is the same outcome that would have arisen had the surviving spouse been given the assets outright; or, in a more flexible variation of the

> standard QTIP marital trust, where a fiduciary is given the power to terminate the trust in favor of the surviving spouse at its discretion. Why should the termination of the QTIP trust through the NJA give rise to more than a single incident of taxation? The answer is that it should not. Taxpayer consistency does not support such an outcome, and Respondent's **attempt to achieve triple taxation** is contrary to the IRS's own published guidance applicable to these situations, further undermining confidence in the tax system. Similarly, Linda and Peter have not reduced their potential estate tax obligations, as their gross estates would be taxed on the assets of the Residuary Trust only to the extent of gifts or bequests from Bruce. This is the same circumstance that would have existed had the Residuary Trust been left undisturbed. (Emphasis added)

(7) In response to the IRS alternative argument that the husband's sale of substantially all the QTIP assets in exchange for promissory notes resulted in a disposition of his qualifying income interest in the trust, thus triggering §2519, the taxpayer argued that the husband did not relinquish his income interest. The receipt of the promissory notes was not a disposition of a qualified income interest but was the conversion of QTIP property into other property in which the husband holds an income interest. *See* Treas. Reg. §§ 25.2519-1(f) ("conversion of qualified terminable interest property into other property in which the donee spouse has a qualifying income interest for life is not, for purposes of this section, treated as a disposition of the qualifying income interest"); 25.2519-1(e) (exercise of a power to appoint QTIP assets from the trust to the surviving spouse is not treated as a disposition under §2519).

An interesting article emphasizes the "tax fiction" created by the QTIP regime that in effect treats the spouse as owning the trust assets for transfer tax purposes, similar to the arguments being made by the taxpayer in *McDougall*. Irwin, *Removing the Scaffolding: The QTIP Provisions and the Ownership Fiction*, 84 NEB. L. REV. 571 (2005).

b. **Planning Regarding Spouse's Interest in QTIP Trusts.** Planning for surviving spouses who are beneficiaries of substantial QTIP trusts is complicated but very important because assets remaining in a QTIP Trust at the surviving spouse's death will be included in the spouse's gross estate for estate tax purposes. The §2519 issue appears to be a focus of the IRS. John Porter, attorney representing the taxpayer in *McDougall*, says he is aware of three of these types of cases currently in litigation.

For an outstanding detailed discussion of planning alternatives for a surviving spouse who is the beneficiary of a QTIP trust, see Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12 1202.3 (2010). For a discussion of other planning alternatives (including planning for distributions to the spouse, and the risks of unauthorized distributions, so the spouse can make estate planning gifts and transfers of those assets), see Item 9.h of Estate Planning Current Developments and Hot Topics 2022 (December 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

30. Purchase Agreement Not Respected for Valuation Purposes under Section 2703, *Huffman v. Commissioner*, T.C. Memo. 2024-12

a. **Synopsis.** Chet Huffman, son of donors, entered into an agreement in 1993 with a trust funded by donors (the trust presumably was a revocable trust) and an agreement with an S corporation owned entirely by his mother giving him an option to purchase the shares of a Company that manufactured and supplied engineering components to the aerospace industry (the "RTP agreements"). Chet had become the CEO of the Company six years earlier (when his father, who was the prior CEO, had a near fatal off-road racing accident [he was a member of the Off-Road Motorsports Hall of Fame]). The RTP agreements gave Chet the right to acquire the shares for a price not to exceed $3.6 million and $1.4 million, respectively, at the deaths of his parents or under a right of first refusal. An addendum gave Chet the right to acquire the shares at any time but required consent from various people to override alienability restrictions. The Company would have to increase in value by a very large amount, from about $0.49/share to $11.83/share (2,314%!) [i.e., increase of $11.83 - $0.49 = $11.34; and 11.34/0.49 = 23.14, or 2,314%] before the shares would be "in the money." Chet exercised the right to purchase the shares in 2007, paying the $5 million with a note.

No 2007 gift tax return was filed. The accountant never suggested to Chet's parents there was potential gift tax liability or the need to file a gift tax return. At some point, the IRS argued that a gift was made from the parents in 2007 when Chet purchased shares that were worth more than the $5 million exercise price.

The court determined that the burden of proof did not shift from the donors to the IRS. A 5%-6% reduction in the IRS's valuation position at trial as compared to the notice of deficiency was not enough to shift the burden of proof.

The court found that §2703 applied, so the agreement could not "be respected for valuation purposes." The first two elements of the safe harbor in §2703(b) were satisfied, but the third was not. (1) The parties agreed the agreement had a valid business purpose (maintaining managerial control or family ownership). (2) The agreement was not a testamentary device to transfer property to members of the family for less than full consideration because Chet paid adequate consideration for the option agreements (taking into consideration reduced compensation he received as CEO) and because the "unusual" level of growth suggested the agreement was meant to incentivize Chet rather than to transfer property to him for less than full value. (3) The third requirement, that the terms of the agreement were comparable to similar arrangements entered into in an arm's length transaction, was not satisfied. A suggested comparable arrangement was not comparable, in part because of procedural issues (the other agreement was not entered into evidence). Even aside from the evidentiary issue, the other agreement was not comparable largely because Chet's agreement could be exercised at any time but the other could be exercised only at a person's death or under a right of first refusal.

The court reviewed the opinions of the parties' experts (government's expert at $31.3 million and taxpayers' expert at $16.3 million as the value of the purchased shares) and determined that the IRS's appraisal was more appropriate (with several revisions), so the gift was the difference between the appraised value (as adjusted) and the $5 million paid by Chet in exercising the option. (The adjustments to the position of the government were not clear from the opinion but may have been as much as $10 million.) The IRS's expert opinion concluded that a 10% lack of control and 20% lack of marketability discount were appropriate.

The court also addressed income tax issues (for example, in one transaction the parties overvalued the portion of sale proceeds from a subsequent sale of assets by the corporation and affiliated entities that were allocated to goodwill, and correcting that resulted in increased capital gain to the corporation and a constructive dividend to the taxpayers.) The court also addressed accuracy-related penalties under §6662 and failure to file and pay penalties under §6651. The court determined that the reasonable cause exception applied (except for one conceded matter) because of reasonable reliance on professional advice, so penalties generally were not applicable. *Huffman v. Commissioner*, T.C. Memo. 2024-12 (January 31, 2024) (Judge Ashford).

b. **Burden of Proof.** The court determined that the burden of proof did not shift from the donors to the IRS. *See* §7491(a). The taxpayers argued that the burden of proof should shift to the IRS because the asserted valuation at trial was less than in the notices of deficiency. The court considered prior cases holding that the IRS forfeits the presumption of correctness by conceding the assessed deficiency was erroneous (*Estate of Simplot*) and that the IRS had assumed the burden of proof by be reducing the alleged valuation at trial by 19%, which caused the court to find that the initial assessment was "arbitrary and excessive" (*Estate of Mitchell*). The court determined that the 5%-6% reduction at trial in this case did not mean the initial valuation was "arbitrary and excessive."

   The burden of proof determination was important because the court did not base its decision on a preponderance of the evidence, but the donors "failed to meet the burden of proof regarding why their expert's valuation is correct."

c. **Section 2703.** The court found that §2703 applied, so the agreement could not "be respected for valuation purposes."

   Section 2703(a)(1) provides that the value of any property must be determined without regard to "any option, agreement, or other right to acquire or use the property at a price less than the fair

market value of the property (without regard to such option, agreement, or right)." Section 2703(b) provides an exception to §2703 for any agreement that meets all of three listed requirements. The first two elements of the safe harbor in §2703(b) were satisfied, but the third was not.

(1) **Business Purpose Test.** The parties agreed that the agreement had a valid business purpose (maintaining managerial control or family ownership was an appropriate purpose).

(2) **Device Test.** The agreement was not a device to transfer property to members of the family for less than full consideration. The court gave two reasons. First, one factor is "the fairness of the consideration received by the transferor when it executed the transaction" (citing *Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60, and *Estate of True v. Commissioner*, T.C. Memo. 2001-167). The court concluded that Chet paid adequate consideration when he entered into the option agreements (taking into consideration reduced compensation he received as CEO). Second, the court noted the "unusual and unexpected" huge level of growth required before the agreement would be exercised, which "incentivized Chet both to stay with the company and to increase its per-share value," and which suggested the agreement was not intended to transfer shares to him for less than full consideration. (The court did not mention the conclusion in *Kress v. U.S.*, 123 AFTR 2d 2019-1224 (DC Wis. 2019), that the reference in §2703(b)(2) to "members of the decedent's family" means that the device test applies only to transfers at death and not to inter vivos transfers.)

(3) **Comparability Test.** The third requirement, that the terms of the agreement were comparable to similar arrangements entered into by persons in an arm's length transaction, was not satisfied.

The court noted that the §2703(b) exception is "more of a safe harbor than an absolute requirement that multiple comparables be shown" (quoting *Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60) and that an "isolated comparable" can be used to satisfy the comparability test (citing *Estate of Amlie v. Commissioner*, T.C. Memo. 2006-76).

The donors pointed to a somewhat similar agreement with an unrelated party regarding the Company's stock. An agreement entered into in 1990 (the "Lloyd-Barneson agreement") gave Chet's father (Lloyd) the right to purchase shares in the Company owned by Barneson, an unrelated shareholder, for a price not to exceed a certain amount, which could be exercised at Barneson's death or under a right of first refusal. The father assigned his rights under that agreement to Chet in 1993, and later that year Chet and Barneson agreed that Chet would buy his shares for $150,000. The Lloyd-Barneson agreement was presented as a "comparable arrangement." The taxpayers pointed out various similarities with RTP agreement, including: (1) a right to purchase on the death of the grantor and by a right of first refusal; (2) a maximum purchase price; and (3) no specific termination or exercise date. The court determined that this other agreement was not comparable partly on procedural grounds because the Lloyd-Barneson agreement had not been introduced as evidence. Even aside from the evidentiary issue, the court noted some provisions that made Chet's agreement less valuable (he had to obtain more consents to transfer his purchase rights), but others that made it more favorable (he could exercise it any time rather than just at death or upon a right of first refusal). Those differences were enough to make it not comparable. The court cited *Estate of Blount v. Commissioner*, T.C. Memo. 2004-116 (finding that solely testimony without production of comparable agreements was insufficient to satisfy §2703(b)(3)), *aff'd in part, rev'd in part and remanded*, 428 F.3d 1338 (11th Cir. 2005).

d. **Ultra-Strict Comparability Analysis.** The *Huffman* analysis seems remarkably strict in its application of the comparability test (aside from the procedural evidentiary issues). Look at the similarities between the RTP agreement and the comparable agreement with the unrelated third party, Barneson:

- Both agreements involved the exact same Company.
- Both agreements involved an option-to-purchase arrangement rather than a mandatory purchase.

- Both agreements allowed the person holding the option to exercise a right of first refusal if someone else wanted to buy the stock.
- Both agreements would extend through the deaths of the sellers.
- Both agreements were signed in the same general time frame. Chet negotiated to purchase shares from the third party (presumably using the framework of the 1990 Lloyd-Barneson agreement and the price at which Chet knew he could purchase Barneson's shares at his death) in August 1993, and Chet entered into the RTP agreement in November 1993.
- Both agreements were transferable, but Chet's agreement required that he get more consents than in the comparable agreement.
- Neither agreement involved put rights, drag along rights, or tag-along rights.

As buy-sell agreement go, that's a **lot** of similarities.

The big difference the court latched onto was that Chet could exercise his option under the RTP agreements at any time whereas the comparable was exercisable only at the death of Barneson or in the exercise of a right of first refusal. But this arrangement under the RTP agreements was one where the option was not going to be exercised in any event for a considerable length of time. There would be no reason to exercise the option until the company had grown by 23 times its value!! (The IRS's expert valued the shares at $0.51/share. Even in that expert's view, the company would have to grow by 22 times before it would be "in the money" [$11.83 - $0.51 = $11.32; $11.32/$0.51 = 22.20, or 2,220%].) The court observed that based on the assumptions of Chet and Barneson in their arm's length negotiation in 1993, "the RTP agreements would have taken between 50 and 70 years to reach an 'in the money' value." Chet's parents would have both died within that 50-70 year time frame. Even if the RTP agreements had been exercisable only at death, the expectation at the time they signed the agreements was that they would not have been exercised before that time anyway. In that respect, the timing of purchases under the two agreements was not that different.

The big difference, in terms of comparability, would seem to be the price terms, but the court expressed no concern over pricing differences between the two agreements. The court also did not express any concern with whatever differences may or may not have existed between the payment terms.

The court could have based its decision on the evidentiary issue, and that would have been totally understandable. But to base its decision in part on the lack of comparability with the Barneson agreement is hard to fathom. It's almost as if the only way to satisfy the comparability test is to come up with an agreement involving the same company for exactly the same terms. That flies in the face of statements in the §2703 regulations. *E.g.*, Reg. §25.2703-1(b)(4)(i) ("if it conforms with the general practice of unrelated parties under negotiated agreements in the same business"); §25.2703-1(b)(4)(ii) ("a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods. It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement."). And the legislative history similarly anticipated the use of a much more reasonable comparability standard. This is from the Conference Report:

> The conferees do not intend the provision governing buy-sell agreements to disregard such an agreement merely because its terms differ from those used by another similarly situated company. The conferees recognize that general business practice may recognize more than one valuation methodology, even within the same industry. In such situations, one of several generally accepted methodologies may satisfy the standard contained in the conference agreement.

At the time the option was exercised by Chet, the Company had grown tremendously (under *his* leadership, not because of what the parents did), and the price per share was much higher than under the option agreement. How could anyone have anticipated that dramatic growth when the RTP option agreements were entered? But it's as if the court was convinced a gift tax should apply when a transfer is made with that big of a valuation disparity between the current value and option price and was looking to find SOME reason not to be bound by the lower price in the option agreement. To

reach that conclusion, the court latched onto a pretty small difference between otherwise very similar option agreements.

e. **Section 2703(b) Analysis Consistent With Various Other Cases Regarding Comparability Analysis.** Unfortunately, the *Huffman* court is following the trend of cases that have applied the comparability test strictly in requiring examples or evidence of actual comparable arrangements negotiated at arm's length. *E.g.*, *Connelly v. United States of America, Department of the Treasury, Internal Revenue Service*, 128 AFTR 2d 2021-5955 (E.D. Mo. 2021), *aff'd*, 131 AFTR 2d 2023-1902 (8th Cir. June 2, 2023), *writ granted* (U.S. Dec. 13, 2023) (No. 23-146) (estate "failed to prove any evidence of similar arrangements negotiated at arms' length" [about determining the purchase price without including life insurance proceeds received by company at decedent's death]); *Kress v. United States*, 123 AFTR 2d 2019-1224 (E.D. Wi. 2019) ("Though Plaintiffs contend *restrictions* like the Kress Family Restriction are common in the commercial world, they have not produced any evidence that unrelated parties at arms' length would agree to such an arrangement."); *Estate of Blount v. Commissioner*, T.C. Memo. 2004-116, *aff'd in part, rev'd in part*, 428 F.3d 1338 (11th Cir. 2005) ("He did not present evidence of other buy-sell agreements or similar arrangements, where a partner or shareholder is bought out by his coventurers, *actually entered into* by persons at arm's length. … Because Mr. Grizzle has failed to provide any evidence of *similar arrangements actually entered into* by parties at arm's length, as required by section 2703(b)(3), and his opinion is based solely on his belief that the purchase price for decedent's BBC shares was set at fair market value, Mr. Grizzle's conclusion that the terms of the Modified 1981 Agreement are comparable to similar agreements entered into by parties at arm's length is unsupportable."); *Smith v. Commissioner*, 94 AFTR 2d 2004-5283 (W.D. Pa. 2004) ("In this case, both parties concede that it would be inherently difficult to find an agreement between unrelated parties dealing at arm's length that would be comparable to a family limited partnership, which, by its terms, is restricted to related parties. … Nevertheless, Plaintiffs have submitted the affidavits of two attorneys … who essentially state that restrictive provisions requiring installment payments and charging interest at the applicable federal rate are common in both family limited partnerships and transactions involving unrelated parties. … Upon review, these affidavits merely state opinions that are conclusory in nature and do not constitute evidence sufficient to dispel any genuine issue of material fact as to whether of [*sic*] the restrictive provision in the Smith FLP agreement meet the test set forth in Section 2703(b)(3).")

The comparability test was satisfied in *Amlie v. Commissioner*, T.C. Memo. 2006-7, involving a rather complicated fact pattern. The court concluded that an agreement met the comparability test because it was based on price terms in an earlier agreement, which was based on a survey of comparables.

31. Valuation of Life Insurance Policies, *M. Joseph DeMatteo v. Commissioner,* Tax Court Docket No. 3634-21 (Stipulated Decision Feb. 22, 2024)

a. **Background.** A recent case involving the gift tax valuation of life insurance policies raises a thorny issue that has been percolating for years about life insurance policy valuations.

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

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

b. **Basic Facts.** In *DeMatteo v. Commissioner*, Tax Court Docket No. 3634-21 (Petition filed April 9, 2021), the donor hired an independent professional consultant, the Ashar Group, to value the policies. (They have a great deal of experience with life insurance policies in the secondary market.) The IRS position, though, was that the regulations mandate using interpolated terminal reserve values plus unexpired premiums to value policies. The donor sought summary judgment that the

regulations do not require that the life insurance policies be valued at the interpolated terminal reserve values plus unexpired premiums.

The court refused summary judgment in an Order dated July 21, 2022, refusing to decide "in the abstract a question of law that may become moot depending on the evidence of the nature of the policies and the quality of the respective valuations."

c. **Settlement.** A stipulated decision entered Feb. 22, 2024, reports an agreed gift tax deficiency of $4,291,077. Presumably, the parties offered additional evidence of the values of the policies and eventually agreed on stipulated values of the policies.

From a planner's perspective, the settlement is disappointing. If the court in this case had ultimately decided on an appropriate approach for valuing the policies, the case could have been quite instructive regarding the valuation of life insurance policies for transfer tax purposes.

32. Reverse Split Dollar Life Insurance, *Cinader v. Commissioner*, Tax Court Docket No. 13491-22 to 13496-22 & 5245-22 (Stipulated Decision Jan. 3, 2024)

a. **Background.** Under a traditional split dollar arrangement, the insured donor pays premiums on life insurance policies owned by a trust. At the insured's death, the insured receives back certain amounts, but the trust receives the balance of the death proceeds. Table 2001 rates may be used for valuing the pure insurance coverage.

Under a reverse split dollar arrangement, an irrevocable trust owns the policy and the insured pays for the right to designate who receives the death proceeds. In *Cinader v. Commissioner,* Tax Court Docket No. 13491-22 to 13496-22 & 5245-22, the insured used the Table 2001 rates to determine the amount paid annually (with a note) to be able to designate the beneficiary in that year (even though, as discussed below, an IRS Notice says the Table 2001 rates cannot be used in the reverse split dollar situation).

b. **Basic Facts.** An irrevocable trust owned a life insurance policy on the insured's life. The insured agreed to pay the trust (with notes) for the right to designate the beneficiary (of death proceeds minus the greater of the cash surrender value or the premiums paid). The Table 2001 rates were used to determine each year's repayment amount. The insured owed the trust $41,168,849 at his death, which amount was deducted on the estate tax return.

The IRS's position was that Table 2001 rates cannot be used to value the pure insurance coverage when the insured does not own the policy. Notice 2002-59. (Table 2001 rates often exceed actual premium amounts.) In *Cinader*, the IRS maintained (i) that the insured made gifts to the trust each year when using the Table 2001 rates to determine the payment amount, (ii) that the insured's debts (the notes) to the trust were not bona fide indebtedness, and (iii) that the debts were therefore not deductible for estate tax purposes under §2053.

c. **Settlement.** A stipulated decision was entered January 3, 2024, reporting agreed gift tax deficiencies of $3,327,230 for 2002, $99,213 for 2023, $1,424,814 for 2012, $8,433,707 for 2013, $1,527,836 for 2015 (total gift tax efficiencies of $14,812,800) and an estate tax deficiency of $14,298,629.