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# Heckerling Musings 2017 and Estate Planning Current Developments

**March 2017**

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## Table of Contents

|   |     |
|---|-----|
| Introduction.....   | 1   |
| 1. Summary of Top Developments in 2016 .....  | 1   |
| 2. Legislative Developments .....   | 2   |
| 3. Estate Planning Considerations In the Face of Legislative Uncertainty and Potential Estate Tax Repeal .....  | 11  |
| 4. Basis Consistency and Reporting Requirements .....   | 26  |
| 5. Treasury-IRS Priority Guidance Plan and Miscellaneous Guidance From IRS.....   | 42  |
| 6. Section 2704 Proposed Regulations.....   | 48  |
| 7. Placebo Planning – Dispelling Common Transfer Planning Myths .....   | 54  |
| 8. Structuring Trusts For Flexibility .....   | 56  |
| 9. Structuring Trusts and Other Planning to Protect Beneficiaries from Divorce Claims .....   | 71  |
| 10. Privacy and Personal Security.....  | 79  |
| 11. Improving GRAT Performance.....   | 87  |
| 12. Installment Sales to Grantor Trusts; Settlement of <i>Woelbing</i> Cases .....  | 92  |
| 13. Self-Canceling Installment Notes (SCINs); <i>Estate of William Davidson</i> ; <i>Estate of Johnson</i> .....  | 95  |
| 14. Defined Value Clauses; Attack on “Wandry” Clause in <i>Estate of True v. Commissioner</i> ...   | 97  |
| 15. Family Limited Partnership and LLC Planning Developments; <i>Purdue, Holliday, Beyer</i> Cases .....  | 100 |
| 16. Portability .....   | 105 |
| 17. State Income Taxation of Trusts.....  | 110 |
| 18. Tax Effects of Settlements and Modifications .....  | 112 |
| 19. Engaging New Clients .....  | 116 |
| 20. Social Security – Rules of Thumb About Age to Claim Benefits.....   | 118 |
| 21. Elder Law Issues; Avoiding Exploitation .....   | 121 |
| 22. Electronic Wills Act .....  | 122 |
| 23. Reporting Charitable Gifts on Gift Tax Return.....  | 123 |
| 24. Trust as Owner of Another Trust, PLR 201633021.....   | 124 |
| 25. Intergenerational Split Dollar Life Insurance Plan Qualified for Economic Benefit Regime Under Split Dollar Regulations, <i>Estate of Morrissette v. Commissioner</i> ..... | 124 |
| 26. ING Trusts – 2016 Letter Rulings .....  | 129 |
| 27. New Procedure for Release of Special Automatic Estate Tax Lien.....   | 130 |

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|   |     |
|---|-----|
| 28. Valuation—Appeals Court Remands Case for Further Company Valuation Review; Tax Court Must Make Its Own Determination of Value If It Finds the IRS Valuation was Arbitrary and Capricious Due to Flaws in Its Expert’s Appraisal, <i>Cavallaro v. Commissioner</i> ..... | 132 |
| 29. Valuation; Approval of Extremely Broad Summons Requesting Information About Prior Clients and Appraisal Work Files, <i>U.S. v. Clower</i> .....   | 133 |
| 30. Interesting Quotations.....   | 134 |

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## Introduction

The 51<sup>st</sup> Annual Philip E. Heckerling Institute on Estate Planning was held in Orlando during the week of January 9, 2017. I have summarized some of my observations from the week, as well as other observations about various current developments and interesting estate planning issues. My goal is not to provide a general summary of the presentations. The summaries provided on the [American Bar Association Real Property, Trust & Estate Law Section website](#), which are prepared by a number of reporters, and coordinated by Joe Hodges, do an excellent job of that. In addition, Martin Shenkman provides a detailed outline summary of each of the presentations, which is available on the Leimberg Information Services website. Rather, this is a summary of observations of selected items during the week as well as a discussion of other items. I sometimes identify speakers, but often do not (some topics are discussed by various speakers). I take no credit for any of the outstanding ideas discussed at the Institute — I am instead relaying the ideas of others that were discussed during the week.

### 1. Summary of Top Developments in 2016

Ron Aucutt (Washington D.C.), provides the following as his “top ten” list of the major developments in the estate planning world in 2016:

- (1) The 2016 election and implications for tax reform (see Item 2.b-d below)
- (2) House Republicans’ tax reform “Blueprint” of June 2016 (see Item 2.b below);
- (3) Reaction to the §2704 proposed regulations (see Item 6.e.(1) below);
- (4) Proposed regulations under §2704 (see Item 6 below);
- (5) Proposed regulations on consistency of basis (see Item 4 below);
- (6) Uncertainty about defined value clauses (discussed generally in Item 14 below, the *Woelbing* cases and *True* cases discussed in Items 12.d-e and 14.f below),
- (7) “Business (purpose) as usual” with family limited partnerships (in *Purdue*, *Holliday*, and *Beyer* cases, as discussed in Item 15 below);
- (8) QTIP elections on portability-only estate tax returns (Rev. Rul. 2016-49, discussed in Item 16.b below);
- (9) Unannounced apparent changes in IRS policies and practices, including the procedure for obtaining waiver of estate tax liens (see Item 27 below) and the refusal to issue future letter rulings regarding the GST implications of trust modifications (see Item 5.g below); and
- (10) Developments in split-dollar life insurance, including the *Morrisette* case (see Item 25 below).

Aucutt, *Ron Aucutt’s “Top Ten” Estate Planning and Estate Tax Developments of 2016*, McGuireWoods Website (posted Dec. 21, 2016).

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## 2. Legislative Developments

- a. **Presidential Election.** With the election on November 8, 2016, Republicans now hold the Presidency and majorities in the House and Senate, making tax reform a very realistic possibility for 2017. In light of the significant possibility of repeal of the estate and GST tax, estate planning considerations for clients were changed overnight on November 8.
- b. **House Republicans and Trump Proposals Regarding Tax Reform (Including the Transfer Tax); Process for Tax Reform Changes.** The House Republican tax reform package is described in a document published on June 24, 2016 entitled "A Better Way" (and referred to as a Blueprint for Tax Reform"). The Report says that it is premised on addressing the broken tax code, the broken Internal Revenue Service, and the need for stronger economic growth. The tax reform measures include:
- Individual: Top rate-33%; capital gains and dividends-50% exclusion (equivalent to a top rate of 16 ½%); no itemized deductions except mortgage interest and charitable deduction; no AMT; no 3.8% tax on NII; "continue the current tax incentives for [retirement] savings;"
  - Tax simplification for individuals, proposing a "Simple, Fair 'Postcard' Tax Filing:"

|  |       |
|--|-------|
| 1. Wage and compensation income                      | _____ |
| 2. Add ½ of investment income                        | _____ |
| 3. Subtract contributions to specified savings plans | _____ |
| 4. Subtract standard deduction OR [lines 5-6]        | _____ |
| 5. Subtract mortgage interest deduction              | _____ |
| 6. Subtract charitable contribution deduction        | _____ |
| 7. Taxable income                                    | _____ |
| 8. Preliminary tax (from tax table)                  | _____ |
| 9. Subtract child credit                             | _____ |
| 10. Subtract earned income credit                    | _____ |
| 11. Subtract higher education credit                 | _____ |
| 12. Total tax  | _____ |
| 13. Subtract taxes withheld                          | _____ |
| 14. Refund due/taxes owed                            | _____ |
  - Business: Corporate top rate-drop from 35% to 20%; pass through business income top rate of 25% (with a requirement that "businesses will pay or be treated as having paid reasonable compensation to their owner-operators"); immediate write-off of business investments in tangible and intangible assets (but not land); no corporate AMT;
  - Border adjustment provisions (taxing certain imports but not exports), which accounts for substantial revenue to offset partially the large tax cuts in other parts of the plan; replacing the "outdated worldwide tax system" with a territorial tax system; and
  - Repeal estate and GST tax.

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The Trump/Pence website has summarized the Trump tax reform proposals, which include:

- Individual: Top rate-33%; capital gains and dividends-20%; cap itemized deductions at \$200,000 (joint), \$100,000 (single); no AMT; no 3.8% tax on NII;
- Business: Corporate top rate-drop from 35% to 15%; pass through business income top rate of 15% (in the first Trump plan); and
- Transfer tax: “repeal the death tax, but capital gains held until death and valued over \$10 million [presumably that is per couple] will be subject to tax to exempt small businesses and family farms. To prevent abuse, contributions of appreciated assets into private charity established by the decedent or the decedent’s relatives will be disallowed.” (The last sentence presumably would eliminate the charitable deduction for gifts of appreciated assets to a private foundation created by the donor or the donor’s family.)

The proposal does not clarify whether the \$10 million exemption is applied per couple or per individual. Also, the proposal is not clear as to whether it would impose capital gains at death or merely establish a carryover basis on gains. Informal reports are that the Trump campaign confirmed for one inquirer that the intent was to propose a carryover basis approach, not realization at death.

Interestingly, Hillary Clinton also announced a rather startling proposal on September 22, 2016 regarding transfer taxes *and* gain realization for gifts and bequests. (The Clinton proposal would have reduced the estate, gift and GST exemption to \$3.5 million and increased the rate, with a top rate of 65%.)

- c. **Introduction of Estate Tax Repeal Bills.** Sen. John Thune (R-S.D.), who is the chairman of Senate Republican Conference, which is the number three position in Senate Republican leadership reintroduced legislation (with various co-sponsors) on January 24, 2017 to repeal the estate tax (S. 205). The Death Tax Repeal Act of 2017 is very similar to legislation introduced in last year’s session (and that was adopted as part of the non-binding fiscal year 2016 budget resolution). On the same day, Reps. Kristi Noem (R-S.D.) (with various co-sponsors) filed a similar (not identical) bill in the House (H.R. 631). Those bills would do the following –
- Chapter 11 (the estate tax) would not apply to the estates of decedents dying after the date of enactment (new §2210).
  - The GST tax would not apply to transfers after the date of enactment (new §2664).
  - The gift tax would be retained, with an indexed exemption and indexed annual exclusion, but the top rate would be lowered to 35%.
  - Chapter 14 would be retained (presumably to protect the gift tax).
  - For QDOTs, no estate tax would be imposed at the surviving spouse’s death, but estate tax would be imposed on principal distributions for 10 years after the date of enactment if the decedent who created the QDOT died before the date of enactment.

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- Basis adjustments at the decedent's death would continue to apply despite the repeal of the estate tax.
  - A very curious provision in S. 205 (but not in H.R. 631), §2511(c), provides that a transfer to a trust will be treated as a completed gift unless the trust is a grantor trust as to the donor or the donor's spouse. While originally intended to address another issue that is now largely irrelevant, the effect is to eliminate "ING" trusts designed to as a technique for avoiding state income taxes, as discussed in Item 26 below. See Ed Morrow, *Introduction of the "Death Tax Repeal Acts of 2017" –How the Proposed Bills Differ, in their Attack on INGs of All Things, and Threats to CRTs*, LEIMBERG ESTATE PLANNING NEWSLETTER #2516 (Feb. 10, 2017).

Whether this is the measure that would be included in tax reform is unknown, but "it is the first language we have been given by Congress for our review." Howard Zaritsky, *Hot Topics in Estate Planning*, at 2 (Jan. 2017).

Additional bills with alternative approaches regarding the repeal effort have also been filed. *E.g.*, H.R. 30 (filed January 3, 2017, "Farmers Against Crippling Taxes Act" repealing all of Subtitle B [estate, gift, GST tax and Chapter 14]); H.R. 198 (filed January 3, 2017, "Death Tax Repeal Act of 2017" repealing all of Subtitle B); H.R. 451 (filed January 11, 2017, "Permanently Repeal the Estate Tax Act of 2017" repealing chapter 11 [but leaving the gift tax, GST tax, and chapter 14 valuation rules intact]).

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

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

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

While the reconciliation act is not subject Senate filibuster, under the “Byrd rule” any single Senator can call a point of order against any provision or amendment that is “extraneous” to the reconciliation process for various prescribed reasons—one of which is an entitlement increase or tax cut that will cost money beyond the budget window of the reconciliation bill (typically ten years) unless other provisions in the bill fully offset these costs. (The actual language of the Congressional Budget Act is cumbersome, stating that

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

The offending provision is automatically stripped from the bill unless at least 60 Senators waive the rule.

The reconciliation process has proved instrumental in being able to pass measures connected with the budget process without the necessity of garnering 60 votes in the Senate. For example, reconciliation was instrumental in the passage of the 2001 and 2003 tax cuts, healthcare reform in 2010, and welfare reform in 1996.

Tax reform will not necessarily have to be subject to a 10-year sunset provision (what some planners refer to as a “sunrise” provision) if 60 votes cannot be secured in the Senate. Some significant tax acts have been passed under the reconciliation process without the sunset provision by finding other “pay-fors” so that net tax revenue decreases do not exceed net outlay decreases outside the budget window. (That was accomplished with the 1997 tax act, but that was in a time of budget surpluses.) The budget resolution could theoretically provide for a 40 or 50 year window, but in the words of Ron Aucutt that “would look sneaky and take political capital.” No discussion of using a lengthy budget window has surfaced so far.

The actual process contemplated for 2017 involves having two reconciliation acts in the same year, which has not happened in the 43-year history of the Congressional Budget Act. That can occur because no budget resolution was passed last year for the October 1, 2016 – September 30, 2017 fiscal year. A 2017 fiscal year (FY 2017) budget resolution was introduced on January 3, 2017, which among other things addresses repeal of provisions of the Affordable Care Act. The plan was to complete a reconciliation act on that measure in April or May, 2017. Among other things, it



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would reduce or eliminate various mandates, taxes and penalties associated with the Affordable Care Act.

After completing the FY 2017 reconciliation act (that would repeal provisions of the Affordable Care Act), the plan was to introduce a FY 2018 budget resolution sometime in May or June 2017, with the goal of completing the reconciliation act by August 2017, and it would deal with tax reform.

Delays that have arisen in the discussion of the Affordable Care Act mean that the FY 2017 act likely will not be completed by April or May. Only one budget resolution can be active at a time; when a FY 2018 budget resolution is adopted, the FY 2017 budget resolution will no longer remain. Alternatives are (i) to wait on introducing the FY 2018 budget resolution until the FY 2017 reconciliation act dealing with the Affordable Care Act is completed (which would greatly delay the time for considering 2018 appropriations and tax reform), or (ii) to adopt a FY 2018 budget resolution that could include reconciliation instructions for repeal of the Affordable Care Act AND tax reform (which would result in a “single, very large and extremely controversial reconciliation bill that could easily be enough to prevent the GOP from getting even a simple majority on their two highest legislative priorities”). Collender, *GOP Grand Scheme on Obamacare Repeal & Tax Reform Quickly Going South*, FORBES (Feb. 12, 2017).

Whether tax reform is accomplished in 2017 is becoming more problematic as each day passes with delays in dealing with “repealing and replacing” Obamacare.

- e. **Estate Tax Repeal History-1986 Tax Reform Act.** Estate tax repeal has been considered by various administrations. One staffer from 1986 has stated that negotiation of the momentous 1986 Tax Reform Act came down to one last item. The legislative staffers told President Reagan that he could get rid of the estate tax, but he would have to give up the B-2 bomber. President Reagan replied that he would rather keep the B-2 bomber.
- f. **Tax Reform Legislative Considerations.**
  - Timing of drafting—the various reform proposals are complex, but the House has been working on its reform measures for some time and legislation has been drafted. Including draft language in a reconciliation bill by the summer is a practical possibility.
  - Priorities—The Trump administration has announced several major initial priorities, including (i) repealing and replacing the Affordable Care Act (the “replacing” part will be difficult and controversial), (ii) immigration reform (and deporting specified categories of illegal immigrants), (iii) additional infrastructure spending, (iv) ending sequestration and building up the military, and (v) tax reform. Repealing and replacing the Affordable Care Act adds considerable complexity to assembling a reconciliation bill; because only one reconciliation bill can be passed each year, a slowdown in negotiations over how to repeal and replace Obamacare could slow the reconciliation process. Pressures are already developing even within the tax reform measures. President Trump opposes the “border adjustability” provisions (taxing imports while exempting exports), but Republican

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Congressional leaders say they are a crucial revenue component of the overall tax reform plan. On a conceptual level, fairness vs. simplicity concepts will complicate the process. Which portions of tax reform will take priority – individuals, businesses, passthrough entities, international, etc.?

- Political pressures—While estate tax repeal is a popular Republican position, at some point, decisions will have to be made about how to allocate “political capital” to the most important of the priorities. A variety of the tax reform measures will particularly benefit wealthy high income earners, and adding estate tax repeal (benefitting couples with over almost \$11 million of assets) may become sensitive for some Congressmen. A Brookings News report highlights these brewing political pressures:

Trump has sought to portray his plan as a pro-growth simplification of the tax code that would benefit the middle class. In a “Contract With the American Voter” published before the election, his campaign said of his proposal: “the largest tax reductions are for the middle class.”

Democrats plan to challenge that claim.

Consider two major provisions on which Trump’s and Ryan’s plans agree: First, they’d compress the existing seven individual tax brackets to three, cutting rates generally across the board. Yet the largest cut would be in the top rate, to 33 percent from 39.6 percent. That rate applies only to those with incomes well within the top 1 percent.

Second, their plans would abolish the estate tax, which applies only to estates worth more than \$5.45 million for individuals and \$10.9 million for couples. Data from the Internal Revenue Service and the U.S. Census Bureau shows that far less than 1 percent of the people who die each year pay any estate tax.

An independent analysis of House Republicans’ “blueprint” found that while households at all income levels would pay less tax, “the highest-income households would receive the largest cuts, both in dollars and as a percentage of income.”

After-tax incomes of the very rich – the top 0.1 percent of U.S. earners, or those with incomes over \$3.7 million – would rise by almost 17 percent. At the same time, the bottom three-fifths of households would gain on average 0.5 percent or less, according to the analysis by the Tax Policy Center, a joint venture of the Urban Institute and the Brookings Institution.

Three-quarters of the total tax cuts would go to the top 1 percent, that study found. Sahil Kapur, Bloomberg News, reported in *Dems prep for GOP tax code fight – Opposition to paint Trump’s overhaul plan as a boon for the rich*, Dallas Morning News, at 4A (Dec. 27, 2016).

Even with these competing pressures, the pressure to pass some manner of significant tax reform is enormous.

- Budget hawks—To what extent will “budget hawks” focus on budget deficits? The tax reform plans have a very large reduction of federal revenues in absolute terms. The House Republican Leadership Blueprint for Tax Reform proposal (June 2016) states that it is revenue neutral, but this is accomplished by (i) applying current policy instead of a current law baseline (i.e., ignoring tax increases scheduled to occur under current law under the assumption that Congress will continue to extend current policy), (ii) applying “dynamic scoring” to include changes in tax revenues resulting from changes in the economy resulting from the reduced taxes, and (iii) assuming that the Affordable Care Act-related tax

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revenues are not part of the tax baseline. The Tax Foundation estimates that the Republican tax proposal would reduce federal revenues by \$2.4 trillion over ten years, but estimates a reduction of only \$191 billion with assumptions of increased economic growth that will be generated by the tax cuts. The non-partisan Tax Policy Center estimates that the House tax plan would have a “static” revenue loss of \$3.1 trillion in the first 10 years, and its “dynamic” analysis placed the revenue loss at between \$2.5 trillion and \$3 trillion, depending on the model used. The Tax Policy Center also estimated that the Trump plan would have a “static” revenue loss of \$9.5 trillion over 10 years; it did not conduct a dynamic analysis of the Trump proposal. See Congressional Research Service, *An Overview of Recent Tax Reform Proposals*, R44771 (Feb. 28, 2017). Furthermore, the revenue estimates of the House Republican plan include the substantial revenue that would be produced by the highly controversial “border adjustments” (taxing imports but not exports); without those provisions the revenue loss would be substantially higher. But the cost of repeal of the estate and GST tax is much smaller (about 2-3% of the total cost), and may not generate as much ire from “budget hawks.” The Congressional Budget Office released a report on January 24, 2017 predicting that assuming the current laws governing taxes and spending remain in place, the deficit would begin growing in 2019 and would grow by \$9.4 trillion in the ten years from 2018-2027. Congressional Budget Office, *The Budget and Economic Outlook: 2017-2027* (January 24, 2017). (Those projections do not take into consideration tax cuts or additional proposed infrastructure and military expenditures.) The “Republican Study Committee,” the main organization for House conservatives signaled that it would not ignore that red ink, with the chairman of the group, Rep. Walker (NC), noting that “without changes to the federal budget, we are on a path to fiscal crisis with spending, deficits and debt continuing to balloon out of control.” Alan Rappeport, *Federal Debt Projected to Grow by Nearly \$10 Trillion Over Next Decade*, New York Times (January 25, 2017).

- Phase-in—The reforms of the estate and gift tax in the 2001 Act were phased in over 10 years—in order to allow other higher priority income tax cuts to take effect earlier.
- 10-year sunset—If estate tax repeal passes, will be it sunset in ten years, like it was in the 2001 Act because of the Byrd rule?
- Timing of tax cuts—Even if a reconciliation act is passed this year with significant tax reform, will the tax cuts take effect in 2017 or beginning in 2018? Would they be retroactive to January 1, 2017?
- Realization at death—If the tax reform includes realization at death concepts, those are entirely new concepts for the American tax system, and will take a significant amount of work (and time to structure and draft). Will replacing the estate tax with another tax imposed at death be viewed as a victory by those constituents who have been pushing for estate tax repeal? See Item 3.e below for more discussion about a realization at death approach.

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- Basis step-up—Will basis step-up remain even if the estate tax is repealed? If so, §1014(b) will need amplification as to what assets will qualify for the basis adjustment at death. See Item 3.d below.

- g. **Predictions.** Members of the Heckerling Estate Planning Institute Advisory Board were polled as to whether estate tax repeal was (i) likely, (ii) 50-50, or (iii) unlikely in 2017. The result: 1/3, 1/3, 1/3.

*Howard Zaritsky:* “I’ve been making predictions about the estate tax for 40 years. So far, I’ve been incorrect. So I’m due. I think the estate tax will be repealed sometime in late 2017, but it will have a 10-year sunrise-with the estate tax popping up again in 10 years.”

*Ron Aucutt:* Ron phrased his ideas about what will happen as “possibilities – predictions are difficult.” He anticipates –

- Tax reform will proceed generally under the House Blueprint, and President Trump will go along.
- The budget reconciliation process will be used to avoid having to obtain 60 votes in the Senate. Getting 60 votes would require 8 Democrat votes; while the Republicans would like to have some Democrat votes (they have emphasized for the last 8 years that the Affordable Care Act was passed without a single Republican vote), they will not be willing to give up enough in negotiation to get that many Democrat votes. (What do they have to give up to get the first Democrat vote, then what else do they have to give up to get the second vote, etc.)
- Sunsetting the new measures (including estate tax repeal) after 10 years “seems perhaps likely” if budget reconciliation is used; in an environment of substantial budget deficits, finding enough “pay-fors” to have a neutral revenue impact is unlikely, but is conceivably possible if estate tax repeal is combined with carryover basis or realization at death.
- If a budget resolution has not been adopted by March, the process may be too late to get finalized in 2017; we should know something about the reform general parameters by the March-May time frame.
- Tax reform affecting businesses and individuals in some manner will get passed in 2017, by the time of the summer recess in August.
- The effective date could conceivably be January 1, 2017 if the reform measures are completed by the August recess, but that is not likely. (Retroactive tax measures raise possible constitutional concerns; the institution of a carryover basis or realization at death retroactive system would likely be challenged by someone.)
- Whether the estate tax repeal is part of tax reform is more problematic. Estate tax repeal results in some revenue loss. If estate tax repeal is combined with stepped up basis, the Republicans will look greedy. If the gift tax is maintained,

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who in the Republican constituency will declare victory? If repeal is combined with realization at death, the constituency will view the leadership as getting rid of the estate tax by making them now deal with the capital gains tax. "The estate tax is particularly tricky and burdensome. Repeal would require political capital the Republican leadership will choose to spend elsewhere."

- If estate tax repeal is included in the reform measures, a phase in of the estate tax repeal provisions is not nearly as likely as it was in 2001 ("the constituencies are excited enough to want to see results *right now*").

*Dennis Belcher:* What happens to the estate tax will also be connected to what happens with basis. The estate tax and basis step-up do not have to "travel" together (and their historic origins were not connected), but estate tax repeal may be combined with some kind of carryover basis or realization at death system (with exemptions).

*Jeff Pennell:* The Republicans eventually need to make good on the promise they have been making for two decades. The estate and GST tax will be repealed, but the gift tax will likely be retained because of a concern about income shifting. Accordingly, chapters 11 and 13 would be eliminated, but chapters 12 and 14 would be retained. The loss of revenue from the repeal of the estate in GST tax may well be offset by the institution of a carryover basis or realization at death system.

- h. **Proposed Retirement Enhancement And Savings Act of 2016 Imposing "Five Year Rule" On Distributions.** The Senate Finance Committee on September 21, 2016 unanimously approved the Retirement Enhancement and Savings Bill of 2016. The bill enhances Section 401(k) retirement plans and makes them more accessible to small businesses. The bill also includes a number of changes to qualified plans and IRAs, one of which is that the distributions would have to be made within five years of the death of the participant for most non-spouse beneficiaries to the extent the total of all of a decedent's IRAs and defined contribution plans exceed \$450,000. Exceptions include distributions to minor beneficiaries, disabled and chronically ill beneficiaries, and those beneficiaries who are not more than 10 years younger than the account owner. The bill provides no exceptions for Roth IRAs. The bill applies to decedents dying after December 31, 2016. (President Obama's budget proposals over the last several years have also proposed requiring that retirement plan assets be distributed within five years of the participant's death, with those same general exceptions.)

The five-year rule would be very difficult to administer. If an owner has multiple accounts totaling more than \$450,000 with different beneficiaries, who determines which accounts (and therefore which beneficiaries) get the benefit of the stretch-out provisions for the first \$450,000? The legislative proposal appears to require a pro rata allocation among beneficiaries. Will separate accounts have to be created to separate the \$450,000 amount not subject to the five-year rule from the balance of the retirement plans?

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The House Blueprint proposal includes a statement that current incentives for retirement savings would be continued. Perhaps the call for changing the distribution rules for qualified plans will wane in light of this general policy approach in the House Blueprint.

### 3. Estate Planning Considerations In the Face of Legislative Uncertainty and Potential Estate Tax Repeal

- a. **Avoid Paying Gift Tax.** Do not make such large gifts that significant gift taxes will be due currently. (No one wants to have the honor of being the last person in the country to pay gift tax.) A corollary of avoiding gift tax is to use defined value clauses in making gift or sale transfers to minimize unexpected gift tax consequences.
- b. **Great Uncertainty for Planning.** The “permanence” of the transfer tax following the “great compromise” made in the 2012 Act is now a laugh. Planning in the current environment of uncertainty about future tax laws is extremely difficult. Do we worry about removing assets from gross estates, or do we assure estate inclusion to achieve a stepped-up basis without any estate tax? Will we again see formula based estate plans, based on whether or not there is an estate tax, realization at death, etc.?

**Window of Opportunity.** Another great uncertainty is that even if some or all of the transfer taxes are repealed, will they stay repealed? At some point, political winds will shift again; could the transfer tax be reinstated? If a 10-year sunset applies, uncertainty will persist as to whether the repeal would be reinstated after 10 years.

- c. **Gift Tax Repeal?** Neither the Republican House tax reform plan nor the Trump tax reform plan explicitly state that the gift tax would be repealed. Various summaries of the plans have stated that they call for gift tax repeal, but gift tax repeal has not been addressed in the plans specifically. Indeed, the House Republican plan specifically mentions the estate and GST tax but does not mention gift taxes. (No one believes that omission was inadvertent.) The Trump plan just mentions “death taxes.”

The gift tax was retained in the 2001 Act reportedly as a backstop to the income tax (to shield against gifting highly appreciated assets on the eve of a sale to lower bracket relatives). Admittedly, the gift tax is not as much of a backstop as it was in 2001 because of the large gift exemption that now applies. If the gift tax remains, transfer planning will continue in importance for families who do not want to make their children wait until they are in their 70s before they can start enjoying the family wealth.

If the gift tax is repealed, some wealthy clients will consider making massive transfers to dynasty trusts, to achieve asset protection goals and as a way of avoiding transfer taxes that may be imposed by future legislatures. Some of these transfers will be made under the laws of “domestic assets protection trust states” allowing the donor to remain as a discretionary beneficiary in the discretion of an independent trustee.

- d. **Basis Step-Up?** The estate tax is not necessarily tied inextricably with basis step up under §1014. The income tax was enacted in 1913 and the estate tax in 1916. Neither mentioned anything about the basis of assets received from a decedent. The

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Revenue Act of 1921 included a rule about the basis of assets passing at death. A 1920 U.S. Supreme Court decision resolved an uncertainty about the provision, and in the mid-1930s Congress incorporated provisions under that reasoning. As string provisions were later added to the estate tax, the basis rules then started to track the estate tax. So, as a historical matter, there is no real linkage between the estate tax and basis step-up at death.

**Additional Guidance Will Be Required.** If basis step up is left in place with estate tax repeal, Congress will have to deal with the complexities of determining what assets passing from a decedent qualify for the basis adjustment under §1014(b). Section 1014(b)(9) now covers all property included in a decedent's gross estate under chapter 11. Probate assets will be covered by §1014(b)(1) ("[p]roperty acquired by bequest, devise, or inheritance"). What types of non-probate assets will also qualify for basis adjustment? For example, will assets in a revocable trust qualify? Assets subject to a general power of appointment by the decedent to appoint the assets to the decedent's creditors or estate? Assets that would have been includable under any of the string statutes (§§2034-2042)? Which string statutes will be included in that list? While no historical linkage exists between the adoption of the basis adjustment provisions and the estate tax, the basis step-up provisions have become parallel with the estate tax over the years, and in the absence of an estate tax, Congress will have to clarify the assets to which basis step-up applies.

**QTIP Trusts.** Would assets in a QTIP trust be entitled to a "second basis step-up" at the surviving spouse's subsequent death? If the estate tax does not exist, §1014(b) would have to be amended to provide a basis adjustment for assets that would have been included in the surviving spouse's estate under §2044 if the estate tax had applied. See §1014(b)(10).

**Community Property Basis Adjustment.** The community property basis adjustment provision in §1014(b)(6) is a good example of how estate tax repeal will have a collateral impact on the basis adjustment provisions. That section provides for the basis adjustment of both the decedent's and surviving spouse's one-half of community property at the decedent's death, but it only applies if at least one-half of the community property was included in the decedent's gross estate under chapter 11. If chapter 11 is repealed, the section obviously would no longer apply. Will the "double basis step-up" for community property survive repeal of the estate tax?

- e. **Realization at Death?** Realization of gains at death has appeal from a policy viewpoint. The gains are taxed at capital gains rates, the tax eliminates the temptation to hold onto assets until death and encourages putting capital to the best use in the economy. Realization at death eliminates death as an investment strategy. Ron Aucutt observes: "But for all its theoretical appeal, it is not especially attractive to the surge of middle class blue collar folks that propelled Trump into office. How will that person accept an income tax at death (or carryover basis) just to keep a small fraction of the country from paying an estate tax?"

**Transfer Planning Still Important.** If realization at death passes as part of the estate tax repeal package, transfer planning may remain very important to remove assets from a person's ownership at death that would otherwise be subject to capital gains taxation. Planning to achieve both discounts and freezing (to reduce the amount

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realized at death) will be in play. Using QTIP trusts may delay the realization until the surviving spouse's death. Funding SLATs may be a way to avoid estate inclusion for either spouse, and may avoid realization at death. To what extent could the client be a discretionary beneficiary of a trust created by that individual and still avoid realization at death? Using dynastic trusts will be favored if a system is not imposed automatically taxing the appreciation in trusts after a specified number of years.

**Significant System Complexity.** A host of peripheral issues will arise with the adoption of a realization at death system. What exemptions? Realization on gifts as well? What would be the impact of having assets owned by trusts (some countries that have realization at death tax the appreciation on trust assets every 21 years)?

An adoption of a deemed disposition at death or gift system in the U.S. would require significant complexity in addressing details of the types of assets that would be subject to the tax. For example, would concepts similar to §§2036, 2038, 2041, or 2042 apply to determine what property that is subject to the tax? The replacement system could be almost as complex as our existing estate tax system. Will special exceptions for spouses and businesses/farms be included?

**Canadian System.** In Canada, a "deemed disposition of property" system applies to gifts and transfers at death. The decedent or donor is deemed to have disposed of the property immediately before the gift or before death. A capital gain, or, except for depreciable property or personal use property, a capital loss may result. In most cases one-half of the capital gain is the taxable capital gain, taxable at ordinary income rates (for 2017 the top effective capital gains rates range from 22.25% - 26.76%, depending on the province). For example, a decedent with \$10 million of assets with zero basis would generally result in capital gains taxes of about 25%, or about \$2.5 million.. Certain types of capital gains qualify for a special deduction; eligible individuals are entitled to a cumulative lifetime capital gains exemption on net gains realized on the disposition of qualified property (including qualified farm or fishing property, and qualified small business corporation (QSBC) shares), resulting in deductions in 2017 ranging from \$412,088 for QSBC shares to \$500,000 for all qualified property. Aside from these rather small amounts, no special exceptions exist for closely held businesses (such as the special §6166 "15-year" deferral provision that applies for U.S. estate tax purposes). The tax on appreciation at death is sometimes referred to in Canada as the "Appreciation Estate Tax" (AET).

If an individual dies between January and October, the tax is due April 30. If an individual dies in the last calendar quarter, the tax is not due until 6 months later.

Canada has a limited like kind exchange provision, but it does not apply at death.

An estate with a surviving spouse can avoid the deemed disposition tax if the spouse elects to take a carryover basis in the assets received from the decedent. (Only outright transfers to spouses qualify for this exception.)

Planning to avoid the deemed disposition at death in Canada often focuses on freeze planning and owning life insurance.



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Applying the same system in the U.S. would result in a major tax increase at death for many estates holding appreciated assets or assets with a negative basis. For example, a couple holding that same \$10 million estate from the prior example would not be subject to capital gains at death or estate tax (using portability to utilize both spouses' exemption amounts).

- f. **Carryover Basis?** Estate tax repeal may not necessarily be combined with carryover basis. Prof. Sam Donaldson observes that while Congress will have to think about the impact of estate tax repeal on basis adjustment, "I do believe we live in a world where we can have a step up in basis even if there isn't an estate tax, because I don't think deficit spending is a problem for the party that is in control, regardless of which party it is. That is someone else's – a future generation's – problem, not ours."

If estate tax repeal is combined with carryover basis, a variety of additional factors arise in the process of planning appropriate alternatives.

- The uncertainty of whether a carryover basis system would be implemented has a huge impact on planning. If the estate tax is repealed without carryover basis or realization at death, lifetime transfers of appreciated assets would generally be disadvantageous from a tax planning viewpoint because the transferred appreciated assets would not receive a basis adjustment at the transferor's death (unless further strategies are employed, as discussed briefly in Item 3.h.(4) below). On the other hand, if carryover basis applies, lifetime transfers would not lose a basis adjustment at the transferor's death.
- Consider giving executors the flexibility to consider the basis of assets in making funding decisions. The executor may consider making distributions that generally equalize the unrealized appreciation received by the various recipients. This could involve a wide variety of factors in particular situations, such as the tax brackets of the recipients, state income tax issues, the likelihood that particular assets would be sold, etc. These considerations may greatly complicate distribution decisions.
- Under a carryover basis system, lifetime sales could be disadvantageous. A sale of appreciated assets to a grantor trust in return for a note could mean that no basis step-up is allowed for either the note or the assets in the trust, thus resulting in an eventual double realization (to the estate or estate recipient when the note is paid and to the trust when the assets are sold). This double realization could be avoided by bequeathing the note to the trust. (The sale to a grantor trust is not governed by the installment sales rules; if the installment sales rules applied, the transfer of an installment note to the obligor would be a realization event under §691(a)(5)(A)(i).)
- Similarly, under a carryover basis system, satisfying GRAT annuity payments with appreciated assets following the grantor's death could result in gain realization by the estate. (That gain realization issue is minimized under current law because the grantor's death during the GRAT annuity term likely results in most or all of the GRAT value being included in the grantor's gross estate and receiving a basis adjustment at the grantor's death.) A possible solution to this problem would be

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to bequeath the right to receive annuity payments to the GRAT so that the obligation to make the payments would disappear. Another solution is to bequeath the annuity payment to a trust that gives the GRAT the power to withdraw all of its assets (which causes the GRAT to be treated as the deemed owner of the trust under §678). See Reg. §1.671-2(e)(6); PLR 201633021. See Item 24 below.

- Real estate developers or other real estate owners have often depreciated the assets, refinanced them, made tax-free exchanges, etc. resulting in a huge negative capital account. If the assets were liquidated currently, the owner could suffer catastrophic losses because of the income tax. The plan for those taxpayers is often to hold the assets until death to get the basis step-up and thereafter sell the assets. A carryover basis system will have a serious negative impact on those taxpayers.

- g. **Review Formula Clauses.** Review formula clauses in existing documents. For example, a classic bequest to a credit shelter trust of the maximum amount possible without incurring estate taxes may become a bequest of the entire estate if the estate tax is repealed. Confirm that is the client's intent.

Observe that the operation of formula clauses may be impacted by repeal legislation in subtle ways. For example, if an individual has a formula general power of appointment if the existence of the power does not cause her estate to incur estate taxes, the general power may not exist at all if it would cause *any* estate tax to be paid by the powerholder. If the estate tax is repealed, however, the general power of appointment would become operative. This distinction could be important if Congress adopts an estate tax repeal/basis step up system that treats property subject to a general power of appointment as being property passing from a decedent for purposes of §1014(b).

- h. **Emphasis on Flexibility.** One possible approach of dealing with the extreme uncertainty in the current environment is to take a "wait and see" approach. If tax reform will proceed in 2017, we may have a general idea of the parameters of the plan by May. Some clients will not want or be able to wait. The primary approach for dealing with the extreme uncertainty in doing current planning for clients is to build in as much flexibility as possible.

(1) **Trust Planning.** Planning to use trusts will continue to be important for their flexibility as well as for their tax and non-tax advantages (including planning for long-term management and creditor protection or "divorce" protection for beneficiaries).

(2) **Formula Bequests.** Formula bequests may be based on whether an estate tax exists or other factors.

(3) **Testamentary Planning: QTIPs and Clayton QTIPs.** A favored approach of many planners for testamentary planning will be the use of QTIP trusts (possibly with a Clayton provision allowing more flexible terms if the QTIP election is not made [or if the transfer tax does not apply], which affords great flexibility). QTIP planning could use a single QTIP plan, or multiple QTIP trusts (for example, if a state estate tax applies with an exemption different than the federal estate tax exemption).

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For clients subject to a state estate tax, this could result in (i) a “standard” QTIP trust for the excess over the federal exemption amount, (ii) a QTIP trust effective only for state purposes for the amount in excess of the state exemption amount but less than the federal exemption amount, and (iii) a Clayton QTIP that has expanded into broader terms for up to the state exemption amount.

An advantage of the single QTIP drafting approach is that the client (hopefully) can understand it, just realizing that it leaves a great deal of flexibility after the first spouse has died. Furthermore, it is not necessarily a bad plan even if the estate tax is repealed (realizing that all plans will need to be reviewed if the estate tax is repealed). Some planners have indicated that the bulk of their testamentary plans will be single QTIP trust plans until we know what will happen with the estate tax.

Consider giving someone the authority to cause the surviving spouse to have a testamentary general power of appointment. If the estate tax is repealed and §1014(b) is not adjusted in the course of repealing the estate tax (which none of the estate tax repeal bills have done, so far), the surviving spouse would still be entitled to a basis adjustment under §1014(b)(4) to the extent that the surviving spouse exercises the testamentary general power of appointment. Otherwise, a basis adjustment would not be allowed at the surviving spouse’s death (because §1014(b)(9) [assets included in decedent’s gross estate under chapter 11] and §1014(b)(10) [assets included in decedent’s gross estate under §2044] would be inapplicable if chapter 11 has been repealed. Alternatively, a testamentary general power might automatically arise if no federal estate tax exists (or if some other objective triggering event applies) at the surviving spouse’s death (but that might automatically generate a significant state estate tax and yield little capital gains tax relief, depending on the particular fact situation). As another alternative, a third person may have the right to grant the surviving spouse a testamentary general power of appointment if no federal estate tax exists. (The clients will have to be comfortable with the possibility that the surviving spouse might at some point have the ability to shift trust assets away from the first decedent-spouse’s family members; otherwise the clients may prefer to forego the opportunity for a basis adjustment at the surviving spouse’s death if the estate tax has been repealed at that time.) To protect the third person holding the power to grant a testamentary general power of appointment, consider (i) adding that the person has no duty to monitor the situation or even to consider exercising the power until requested by designated family members to do so, (ii) giving the third person the ability to grant a testamentary general power of appointment, the exercise of which would be dependent on obtaining the consent of designated persons who are not adverse parties, and (iii) including the broadest possible exculpatory provisions with respect to the exercise or non-exercise of the power to grant a testamentary general power of appointment. See Item 7.d of the Current Developments and Hot Topics Summary (December 2014) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor). Be aware that the actual exercise of a testamentary general power of appointment may be more likely to subject the assets to the decedent-beneficiary’s creditors than if the general power is not exercised (see Item 10.m of the Current Developments and Hot

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Topics Summary (December 2015) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).

(4) **Basis Adjustment Planning.** Planning to leave open the flexibility to cause trust assets to be included in the gross estate of a settlor or trust beneficiary if the settlor or beneficiary has excess estate exemption, to permit a basis adjustment at the settlor's/beneficiary's death without generating any added estate tax, will continue to be important even if the estate tax is repealed as long as a basis adjustment at death is left in the law. Many of the planning alternatives discussed below will depend on how §1014 is adjusted if the estate tax is repealed to clarify what assets will be eligible for basis adjustment at the decedent's death to replace §1014(b)(9) (which refers to assets included in the gross estate). See Item 3.d above.

- **Settlor.** A very flexible alternative to cause estate inclusion for the trust settlor would be to give an independent party the authority to grant a power to the settlor that would cause estate inclusion, such as a testamentary limited power of appointment, which would cause estate inclusion under §§2036(a)(2) and 2038 and result in a basis adjustment under §1014(b)(9).
- **Beneficiary.** Possible strategies include planning for the flexibility:
  - to make distributions to the beneficiary (either pursuant to a wide discretionary distribution standard or under the exercise of a non-fiduciary limited power of appointment);
  - to have someone grant a general power of appointment to the beneficiary (which could be exercisable only with the consent of some other non-adverse party [but not the grantor]; consider using broad exculpatory language for the person who can grant the power of appointment and consider providing that the powerholder has no duty to monitor whether a general power should be granted or possibly provide that the powerholder has no authority to grant a general power until requested by a family member to consider exercising his or her discretion to grant a general power);
  - to use a formula general power of appointment (although the existence of mandated general powers of attorney may not be helpful if a carryover basis system is adopted, depending on what exemptions may exist, and a general power of appointment may subject assets to creditors of the powerholder (see Item 10.m of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor));
  - if the estate tax is repealed, obtaining a basis adjustment because of the existence of a general power of appointment under either of the prior two items may require that the beneficiary actually exercise the general power of appointment in his or her will, which would trigger a basis adjustment under §1014(b)(4) even though a basis adjustment would no longer be available under §1014(b)(9) [because of the repeal of chapter 11]; the actual exercise of a testamentary general power of appointment may be more likely to subject the assets to the decedent-beneficiary's creditors than if the general power is not exercised (see Item 10.m of the Current Developments and Hot Topics

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Summary (December 2015) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor); or

- o to trigger the Delaware tax trap (by the exercise of a limited power of appointment to appoint the assets into a trust of which a beneficiary has a presently exercisable general power of appointment) [but springing the Delaware tax trap would not result in a basis adjustment if chapter 11 is repealed at the time of the beneficiary's death, because §2041(a)(3) would be repealed and §1014(b)(9) would be inapplicable].

See Item 8.m-n below and Item 14 of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor) for a more detailed discussion of these strategies. The 2017 Heckerling materials regarding portability by Lester Law and Howard Zaritsky have outstanding forms for all of these alternatives (including formula general powers of appointment and exercising the Delaware tax trap).

(5) **Limited Powers of Appointment.** Liberal uses of limited powers of appointment provide flexibility. See Item 8.m below. Turney Berry has stated “We sprinkle powers of appointment like pixie dust.”

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

(7) **Substitution Powers.** Use non-fiduciary substitution powers to cause grantor trust status (which also yields great flexibility for the donor to purchase favored or low-basis assets from the trust) and include provisions authorizing someone other than the donor to remove the substitution power.

(8) **Trust Protectors.** Consider giving an independent person (sometimes referred to as a “trust protector”) broad flexibility to modify the trust based on changes in tax laws or if the donor’s “net worth drops below a certain level that is unforeseen and independently significant.” Alan Gassman, Christopher Denicolo, Kenneth Crotty & Brandon Ketron, *The Reversible Exempt Asset Protection (“REAP”) Trust for 2017 Planning*, LEIMBERG ESTATE PLANNING NEWSLETTER #2500 (January 11, 2017) (hereinafter “Gassman et al, “REAP Trust”).

See Item 8.q for further discussion about trust protectors.

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

(10) **Trust Protector Adding Donor as Beneficiary.** Considering giving a trust protector the ability to add the donor as a discretionary beneficiary if the trust is established under the laws of a domestic asset protection trust state “if described

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conditions are satisfied, such as the donor's net worth dropping below a certain level, if the federal estate tax is repealed, or the protector determines that the estate tax is no longer a concern to the donor's family." *Id.* (The grantor might include himself or herself as a discretionary beneficiary of the trust from the outset if the grantor resides in a self-settled trust (DAPT) state. If the grantor lives in another state and attempts to apply the laws of a DAPT state, the laws of the domicile state may nevertheless apply under the "strong public policy" exception from being governed by the choice of law provision in the trust agreement. See Item 9.g below. In addition, a debate is ongoing about comment 2 under §4 of the Uniform Voidable Transactions Act (formerly the Uniform Fraudulent Transfer Act), which may cause a transfer by a person from one state that has no legislation regarding self-settled trusts to a trust governed by the laws of a DAPT state as being voidable per se.)

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

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

- i. **Transfer and Freeze Planning.** Clients who want to engage in transfer and freeze planning during the period of uncertainty will focus on alternatives that do not require (or minimize the risk) of paying current gift taxes. Transfer and freeze planning can (i) assist in shifting wealth in case the estate tax is not repealed or is resurrected following sunset of the repeal, (ii) provide creditor protection planning, and (iii) assist in moving assets downstream during life, which is becoming more important as people have longer life expectancies and inheritances are long-delayed. In addition, it may transfer wealth to family members who may be in lower income tax brackets. Richard Franklin (Washington, D.C.) points out that risks associated with moving capital through generations include investment risk, family risk (consumption, creditors), and tax risk (transfer tax, income tax, property tax, etc.). Transferring assets into irrevocable trusts protects against all of those risks. Favored alternatives include the following.

(1) **GRATs.** GRATs will be the favorite approach for many planners because of their certainty, and the assurance that no gift tax is due on creation of the GRAT (because of the adjustment clause that is allowed by the regulations). See Item 11 below for a more detailed discussion about improving GRAT performance.

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(2) **Grantor Trusts.** Grantor trust planning continues to be very desirable for clients with large estates who are interested in transfer planning strategies to reduce estate taxes. Even for more modest estates, grantor trusts afford substantial flexibility. See Item 8.g-k below.

- the grantor pays the income taxes on the trust income so the trust can grow faster and the tax payments further reduce the grantor's taxable estate;
- the grantor can sell additional assets to the trust in return for a low-interest note without gain recognition on the sale (and all of the appreciation can be in a GST exempt trust if GST exemption is allocated to the initial gift to the trust); and
- the grantor has the flexibility to purchase back trust assets.

(3) **Sales to grantor trusts.** Use the gift exemption to provide appropriate "seed capital" and use defined value clauses (either *Wandry* or *Petter* type clauses) or price adjustment clauses to minimize gift risk.

Analytical studies of the financial impact of various strategies demonstrate that sales to grantor trusts can be incredibly efficient in accomplishing wealth transfer, particularly accomplishing wealth transfer in a way that is largely GST exempt.

In several recent cases, the IRS has taken that position that §2036 applies to sales to grantor trust transactions. Planners should take careful steps to create the best defense around a §2036 argument. (See Item 12 below.) Some planners have expressed some ambivalence about sales to grantor trusts, despite their advantages; the *Woelbings* won but had to go through a protracted audit and significant litigation.

(4) **SLATs.** One spouse funds an irrevocable discretionary "spousal lifetime access trust" (SLAT) for the other spouse and perhaps descendants. Assets in the trust avoid estate inclusion in the donor's estate if the estate tax remains and may avoid gain realization at death if that becomes law. Both spouses may create "non-reciprocal" trusts that have sufficient differences to avoid the reciprocal trust doctrine. Assets are available for the settlor-client's spouse (and possibly even for the settlor-client if the spouse predeceased the client) in a manner that is excluded from the estate for federal and state estate tax purposes.

The original settlor could even become a discretionary beneficiary if the spouse predeceases as long as the settlor's creditors could not reach the trust assets under applicable state law, which could occur if DAPT laws apply to the trust or if state spendthrift trust law specifically protects against the settlor's creditors in the "surviving settlor" scenario. *E.g.*, TEX. PROP. CODE §§112.035(d)(2) (settlor becomes beneficiary under exercise of power of appointment by a third party), 112.035(g)(1) (marital trust after death of settlor's spouse), 112.035(g)(2) (any irrevocable trust after death of settlor's spouse), 112.035(g)(3) (reciprocal trusts for spouses)

In addition to avoiding estate inclusion, the trust also provides protection against creditors, elder financial abuse, and identity theft. Over time, the trust can accumulate to significant values (because it is a grantor trust, the client will pay income taxes on the trust income out of other assets) and can provide a source of

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funding for retirement years. (As with any inter-spousal transfers, clients should be aware of potential implications of the transfers on divorce. See Item 9.e below.)

To maximize the creditor protection feature of SLATS (i) the trustee should have the ability to sprinkle distributions among various beneficiaries, (ii) at least one independent trustee should consent to distributions, (iii) any named trust protector should be someone other than the settlor, and (iv) the trustee should be authorized to permit beneficiaries to use assets (rather than having to make distributions for them to enjoy benefits of the trust). For a detailed discussion of SLATs and “non-reciprocal” SLATs, see Items 16-17 of the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).

(5) **Structuring Increased Flexibilities into Irrevocable Trusts.** Irrevocable trusts (including GRATs, grantor trusts and SLATs, as mentioned above) can be drafted to provide additional flexibilities, using alternatives in paragraph h above and in Item 8 below.

(6) **Defined Value Clauses.** To minimize gift tax risks, use defined value clauses when making gifts or sales (of course, GRATs have their own built-in savings clause). See Item 14 below regarding defined value clauses.

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

Alternatively, a noncumulative preferred interest (that does not comply with §2701) could be retained and the common stock could be given. The preferred stock would have a zero value, and the client would need enough gift exemption to cover the common stock. If the estate tax is not repealed at the client’s death, the full value of



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the preferred stock (presumably its liquidation value at par) would be included in the gross estate (resulting in a basis step), but in calculating the estate tax, the use of the unified credit caused by valuing the preferred at zero would be restored under Reg. §25.2701-5(a)(3). The noncumulative retained preferred interest permits some flexibility in the cash flow that will actually be paid to the client (although substantial compliance with the partnership agreement is preferable to avoid potential gift or §2036 consequences.) See Michael N. Goosen & Tracy A. Snow, *Tasty Freeze: Preferred Partnership Tax Recipe*, 42 ESTATE PLANNING 5 (May 2015) and Christopher Pegg and Nicole Seymour, *Rethinking I.R.C. § 2701 in the Era of Large Gift Tax Exemptions*, 87 FL. BAR J. 9 (Nov. 2013). See Item 10.c of the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor) for an example by Ellen Harrison of this planning alternative.

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

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

In order to start the statute of limitations, the return must meet the adequate disclosure requirements of Reg. §301-6501(c)-1(f). See Item 6.e.(4) below regarding the possibility of referring to the §2704 proposed regulations in reporting transfers to satisfy the safe harbor to the adequate disclosure requirements. For a detailed discussion of the background and planning issues around the adequate disclosure rules see Item 20 of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).

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

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

- j. **Testamentary Discount Planning Not As Important.** Even before the estate tax is repealed, planning to produce valuation discounts at an individual’s death has diminishing savings. The estate tax may be lower, but the basis will also be lower, resulting in higher income taxes at some point when the beneficiary ultimately sells

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the assets (or sooner if the assets can be depreciated). With a 40% estate tax and a 23.8% income tax on capital gains (or higher if the state has a state income tax), the savings may be fairly low. If the estate tax is repealed, discount planning can actually be disadvantageous if basis adjustment at death is retained.

- k. **Undoing Prior Planning.** If the estate tax is repealed, planners will be very busy over the next several years undoing prior planning that was implemented to avoid the estate tax. Prior trust and other structures may no longer be helpful and indeed may be detrimental. (See Item 6.l of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and Item 6 of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).) This type of planning may include avoiding the funding of bypass trusts (as described in paragraph l immediately below) under the wills of clients who die without updating their wills, causing previously transferred low-basis assets to be included back in the donor's gross estate, undoing prior discount planning or life insurance trusts that are no longer needed, turning off grantor trust status, and causing inclusion of assets in a beneficiary's (or other third party's) estate.
- l. **Avoiding Funding Bypass Trust.** Countless situations will arise in which a spouse dies with a traditional formula bequest in a will that has not been reviewed in years that creates a bypass trust when the couple has no federal estate tax concerns at the surviving spouse's subsequent death or when the possibility of estate tax repeal exists or the estate tax has been repealed. Creating the bypass trust will create administrative complexity that the surviving spouse may want to avoid and, perhaps more importantly, will eliminate any basis step-up for trust assets at the surviving spouse's death (because he or she would not own the trust assets). For various planning strategies, see Item 18.i below and Item 6.c of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).
- m. **Non-Citizen Spouses.** Bequests or gifts to non-citizens spouses qualify for the marital deduction only if the asset is left to a qualified domestic trust (QDOT). Some estate tax repeal proposals have eliminated the estate tax that would be imposed on a QDOT at the surviving spouse's subsequent death, but have retained the "tail tax" on principal distributions from the QDOT during the surviving spouse's lifetime. (See Item 2.c above.) The possibility of estate tax repeal is a factor that would favor the spouse the becoming a U.S. citizen to be able to avoid the "tail tax" on principal distributions from a QDOT even if the estate tax is repealed.
- n. **Be Very Careful Before Making Lifetime Gifts of Low Basis Assets.** The estate tax savings of gifts are offset by the loss of a basis step-up if the client dies no longer owning the donated property. For example, a gift of a \$1 million asset with a zero basis would have to appreciate to approximately \$2,470,000 (to a value that is 247% of the current value) in order for the estate tax savings on the future appreciation (\$1,469,135 x 40%) – if the estate tax is not repealed – to start to offset the loss of basis step-up (\$2,469,135 x 23.8% for high bracket taxpayers). The required appreciation will be even more if state income taxes also apply on the capital gains. This issue is especially important in light of the possible repeal of the estate tax with a retention of basis adjustment at death.

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- o. **Year-End Planning.** If tax reform has not been enacted by the late fall of 2017 but is still under negotiation, in an environment of possible looming tax reform limiting deductions and lowering rates, generally consider deferring income and accelerating deductions (particularly the charitable deduction if the Trump proposal to limit overall itemized deductions to \$100,000 per year [\$200,000 for a married couple] is still under consideration).
- p. **Revised Charitable Planning Paradigms.** Because no necessity would exist for an estate tax charitable deduction if the estate tax is repealed, a new paradigm would apply to charitable dispositions at death.
- In a family with unified goals about charitable transfers, consider making bequests to individual family members and allowing them to make lifetime gifts to the same desired charities, giving the individuals an income tax deduction. (That type of planning may be limited for large charitable bequests if the tax reform measures limit charitable income tax deductions.)
  - Charitable bequests to trusts would no longer have to be in the form of a qualified interest. Assets could be left to a trust providing that all income would be paid to charity, which would allow the trust to receive a §642(c) income tax deduction, thus, reducing the trust's DNI to zero, meaning that trust distributions to others would not carry out income to them.
- q. **No Immediate Concern Over §2704 Proposed Regulations.** Having a Republican President, Senate and House likely means that the §2704 proposed regulations will not be implemented, at least as long as a Republican administration continues. (Indeed, will the IRS even devote the substantial resources that will be needed to revise the proposed regulations, in light of all the technical comments and concerns about the regulations, if a Trump administration is likely to dictate that the regulations not be finalized?)
- r. **State Tax Planning; Domicile.** State estate and income tax planning will continue to be important, even in the face of possible estate tax repeal. Domicile planning (to eliminate or reduce contacts with high-tax states) can be significant to minimize state taxes.
- s. **Many Planning Issues Beyond Federal Estate Tax Planning.** A practice concern is that fear of the estate tax is often what drives clients into planners' offices, and clients may never enter the planner's office to be informed of the many other reasons that careful planning is needed. In addition, avoiding the estate tax may be the justification, in the client's mind, for paying substantial fees for estate planning services.

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

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1. Planning for the disposition of the client's assets at his or her death.
  2. Asset protection planning.
  3. Planning for disability and incompetency.
  4. Business succession planning (without the estate tax to blame for failure of a business).
  5. Planning for marital and other dissolutions.
  6. Charitable giving (for its own sake, and because income tax considerations will still be relevant and techniques, such as lifetime charitable remainder trusts to facilitate diversification, would not be affected at all).
  7. Life insurance planning (other than to provide funds to pay taxes).
  8. Fiduciary litigation (enhanced because more to fight over).
  9. Retirement planning.
  10. Planning to pay state death taxes (in many states).
  11. Planning to avoid or minimize gift taxes (and client desires to gift more than the \$5 million indexed applicable exclusion amount for gift tax purposes).
  12. Using business entities to accomplish nontax objectives.
  13. Planning for children with disabilities.
  14. Planning for spendthrift children.
  15. Planning for clients with real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues (in addition to state estate tax).
  16. Planning for clients who are U.S. citizens or resident aliens who own property in other countries.
  17. Planning for nonresident aliens with assets in the U.S. or who plan to move to the U.S.
  18. Planning for citizens who intend to change their citizenship.
  19. Planning for possible decrease in the estate, gift, and GST tax exemptions and/or increase in the transfer tax rates.
  20. Planning to pay education expenses, including contributing to I.R.C. §529 plans.
  21. Planning to deal with non-tax regulatory issues, such as the Patriot Act, HIPAA, and charitable governance reform.
  22. Identifying guardians for minor children, if and when needed.

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

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

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

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

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

#### 4. **Basis Consistency and Reporting Requirements**

The basis consistency and reporting requirements enacted in 2015 create basis consistency requirements for beneficiaries and cumbersome reporting obligations for executors. **Neither of those provisions will apply for decedents who die during any time that the estate tax is repealed.**

a. **Background.**

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

(2) ***Legislative Proposals.*** The President's Budget proposal for fiscal years 2010-2016, included a provision requiring gift transferees to use the donor's basis (except that the basis in the hands of the recipient could be no greater than the value of the property for gift tax purposes) and that the basis of property received by death of an individual would be the value for estate tax purposes. A legislative proposal of that approach was contained in section 6 of the Responsible Estate Tax Act of 2010 (S. 3533 and H.R. 5764), in the December 2010 “Baucus Bill,” in section 5 of “The Sensible Estate Tax Act of 2011” (H.R. 3467), Section 1422 of Ways and Means Committee Chairman Dave Camp's Discussion Draft released February 26, 2014, and in section 5 of the “Sensible Estate Tax Act of 2015” (H.R. 1544).

b. **Legislative Provision in Surface Transportation and Veterans Health Care Choice Improvement Act.** The basis consistency provisions for property received

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

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

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

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

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

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

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

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

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

**When Are Reports Due?** Under the statute, such statements must be furnished at the time prescribed in regulations, but no later than 30 days after the return’s due date, including extensions (or 30 days after the return is filed, if earlier).

§6035(a)(3)(A). The Form 8971 Instructions relax this to say that if the Form 706 is filed after the “due date,” the Form 8971 and Schedule(s) A to beneficiaries are due 30 days after the “filing date” (apparently referring to the actual date the Form 706 is filed late). If valuation or other adjustments are made after the statements are furnished, supplemental statements must be furnished within 30 days of the date of the adjustment. §6035(a)(3)(B). ACTEC Comments to the IRS dated May 27, 2016 regarding proposed regulations to §6035 request that the final regulations “confirm

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the Instructions by providing that if the first estate tax return is not timely filed, Form 8971 and Schedule(s) A are due 30 days after the first estate tax return is filed.”

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

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

e. **Penalties.**

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

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

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

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

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

f. **Effective Date.** The amendments to §§1014(f), 6035 and 6724(d) described above “shall apply to property with respect to which an estate tax return is **filed after** the date of the enactment of this Act.” §2004(d) of the Act. This applies not only to

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returns required after but also to any returns actually filed after the date of enactment (July 31, 2015). See Item 3.i.(1) of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor) for a discussion about supplemental estate tax returns filed after the effective date.

- g. **Form 8971.** Form 8971 and its Instructions were released on January 29, 2016.
- Part I of Form 8971 lists general information about the decedent and executor.
  - Part II lists information about beneficiaries (including TIN, address, and the date that Schedules A are “provided” to each beneficiary).
  - A Schedule A is attached to provide information to each estate beneficiary. The Schedule A includes the Form 706 Item number and description of property that the beneficiary has acquired from the decedent. For each asset listed, the executor indicates whether the asset increases estate tax liability and provides the valuation date and value. Schedule A contains a “Notice to Beneficiaries” directing the beneficiary to retain the schedule for tax reporting purposes and informing the beneficiary that if the property increased the estate tax liability, the Code requires consistent reporting of basis.
  - If the executor is also a beneficiary, the executor will have to send a Schedule A to himself or herself. (The Instructions state that if the executor is also a beneficiary, “the executor is a beneficiary for purposes of the Form 8971 and Schedule A.”)
  - The executor is directed to “[s]ubmit Form 8971 with a copy of each completed Schedule A to the IRS.” The Instructions direct the executor to file the Form 8971 with all Schedules A to the IRS within 30 days after the due date (but if the return is filed late, within 30 days of the filing date) of the estate tax return. The Form 8971 and attached Schedule(s) A are not to be filed with the Form 706, but must be filed separately. If values are adjusted, a Supplemental Form 8971 and Schedules A must be filed with the IRS within 30 days after the adjustment.
  - Beneficiaries only receive Schedules A and not the Form 8971 itself. The Schedules A must be “provided” (in person or by email, U.S. mail or private delivery service) within 30 days of the due date of the estate tax return (or within 30 days of the filing date if the return is filed late). If adjustments are made to assets listed on the estate tax return (such as values or the inclusion of additional assets), an updated Supplemental Schedule A must be given to each affected beneficiary within 30 days of the adjustment.
  - If a beneficiary’s distributions have not been funded when the Form 8971 is filed, the Instructions instruct (the stricken words were in the January 2016 Instructions, replaced in the September 2016 Instructions with the bold-font words):
    - the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary’s distribution on that beneficiary’s Schedule A. (This means that the same property may be reflected on more than one Schedule A.) A supplemental Form 8971 and corresponding Schedule(s) A ~~should~~ **may, but aren’t required to** be filed once the distribution to each such beneficiary has been made.



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

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

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

Listings of bulk assets may be attached to Schedule A in lieu of a detailed description of each item that has been acquired (or is expected to be acquired) by a beneficiary. The listing should consist of a related property (for example, stocks held in a single brokerage account) and only include information relevant to basis reporting such as name/description of the property, value, and valuation date. Do not attach property appraisals to Schedule A.
- The “Who Must File” section clarifies that a Form 8971 is not required for an estate that files an estate tax return file solely to elect portability.
- For unfunded bequests, when Schedule(s) A identify several beneficiaries who might receive the same property, “the estate may, but isn’t required to, file a supplemental Form 8971 and Schedule(s) A to specify the actual distribution of that property among the identified beneficiaries.”
- The “Penalties” section makes clear that an executor may be subject to penalties for failing to file Forms 8971 and Schedule(s) A even if no tax was due on the estate tax return.
- If a beneficiary does not have a TIN and one is requested from the beneficiary in writing by the executor, the Form 8971, Part II, column B should enter “requested” for that beneficiary, and a copy of the solicitation should be attached. “A supplemental Form 8971 and corresponding Schedule A must be filed with the IRS once the TIN has been obtained.” If a foreign beneficiary isn’t required to provide a TIN, enter “Not Required” in the TIN entry space.
- The January 2016 Instructions required attaching a Form 2848, Power of Attorney. The September 2016 instructions provide more detail, including: (i) in line 1, the executor is the “taxpayer” and the executor’s TIN should be listed; and (ii) in line 3, “enter ‘Civil Penalties’ in the Description of the Matter column, ‘Form 8971/Schedule A’ in the Tax Form Number, and the decedent’s date of death using the four-digit year and two-digit month as ‘YYYYMM’ in the Year(s) or Period(s) column.” [Observation: “Civil Penalties”??? Yikes!!]
- The Schedule A section clarifies that cash isn’t reportable: “A cash bequest acquired (or expected to be acquired) by a beneficiary isn’t considered reportable property for purposes of Form 8971/Schedule A.” [That sentence’s reference to “Form 8971/Schedule A” instead of just referring to “Schedule A” suggests that a beneficiary who is only receiving cash would not be listed in Part II of Form 8971.

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Including that beneficiary on Part II of Form 8971 would not make sense because column D requires specifying the date that valuation information is provided to beneficiaries and no Schedule A would be provided to that beneficiary.]

- The Schedule A section also clarifies that values to be reported on Schedule A are the estate tax values, without reflecting any post-death adjustment in value, and are the full gross values of property, unreduced by “mortgages, non-recourse indebtedness, or other decreases in equity.” It also clarifies that if multiple beneficiaries receive partial interests in the same property, proportional values should be listed for each beneficiary.

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

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

- The final value for estate tax purposes sets the *initial* basis; normal post-death basis adjustments are still applicable;
- For property subject to non-recourse debt, the basis is the gross value of the property, not just the net value reported on the estate return;
- The reporting requirement does not apply to estates that are not required to file estate tax returns but do so merely to make the portability election;
- Property that qualifies for the marital or charitable deduction is not subject to the basis consistency requirement, but is subject to the reporting requirements;
- Tangible personal property that does not have a marked artistic or intrinsic value over \$3,000 is not subject to the basis consistency or reporting requirements;
- After-discovered or omitted property gets a basis of zero if the property is not reported on an estate tax return before the period of limitations on assessments has expired;
- The Form 8971 and Schedule(s) A to beneficiaries can omit cash, IRD, tangible personal property (as described above), and property sold before the information reports are due;
- For bequests to a trust, estate or entity, the Schedule(s) A are given to the trustee, executor or entity (not the trust beneficiaries);
- For life estates, Schedule(s) A must be sent to the life tenant and presumptive remainderman (and if the initial remainderman dies before the life tenant, the executor apparently must send supplemental reports to the IRS and to the new remainderman);
- If the executor has not determined what property will be distributed to a beneficiary when the information report is due, all property that could be used to

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satisfy the bequest must be included on the Schedule A to that beneficiary (and the executor does not have to send supplemental reports to the IRS and to that beneficiary after the bequest is funded);

- The executor must file a supplemental Form 8971 with the IRS and send supplemental Schedule(s) A to beneficiaries if any previously reported information is incorrect or incomplete (such as if the final estate tax value is changed), but a supplement is not needed for inconsequential errors or omissions;
- If a recipient of an asset in the gross estate makes a subsequent gift or distribution to a “related transferee” (which, for some strange reason, includes a grantor trust but not a non-grantor trust for a related party) the recipient must file a Schedule A with the IRS and transferee reporting the change in ownership and final estate tax value of the property; and
- The Form 8971 and Schedule(s) A to each beneficiary are due 30 days after the earlier of the due date or the date the estate tax return is actually filed (as required by the statute); the proposed regulations do not adopt the relaxation of the due date in the Instructions to Form 8971 saying that if the estate tax return is filed late, the information reports are not due until 30 days after the date the return is actually filed.

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

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

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

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

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bears estate taxes will not want the property reported but the party who receives the asset will want it reported to have a basis equal to the date of death value of the asset.

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

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

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

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

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beneficiary. Presumably the beneficiary would not need a supplemental statement because the beneficiary would know what property was actually received and can find the property listed on the initial statement.

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

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

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

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

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

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

(5) **Subsequent Transfers.** A surprise in the proposed regulations is the requirement for recipients of a decedent’s property to provide a “supplemental Statement” (i.e., a Schedule A) with the IRS and a transferee upon making

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subsequent distributions or transfers to a “related transferee” in which the basis is determined, in whole or in part, by reference to the recipient/transferee’s basis (for example, a gift or contribution to a partnership or LLC). Prop. Reg. §1.6035-1(f). If the subsequent transfer occurs before the final value is determined, the recipient/transferee must also give the executor a copy of the information Statement that is provided to the IRS and transferee, so that if the executor subsequently provides any information Statements, they can be given to the new transferee.

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

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

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

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

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

Whether or not the creation of a perpetual chain of title to aid the IRS in enforcement of section 1014(f) may be desirable as a matter of policy, it is not the policy Congress reflected in section 6035 when it limited the reporting requirement to an “executor,” and, indeed explicitly eliminated from the Administration’s legislative proposal the statutory imposition of a similar reporting requirement on donors of gifts.

**Subsequent Distribution From Trust Recipient.** What about a transfer from a decedent’s estate to a trust and later distribution from the trust to a beneficiary? The trust clearly is a recipient and is making a subsequent transfer in which the basis is

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

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

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

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

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

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

**Information Statement.** The term “Statement” is defined to be Schedule A of the Form 8971 (or any successor schedule issued by the IRS). Prop. Reg. §1.6035-1(g)(3). Therefore, information regarding subsequent transfers will be described on a Schedule A (both to the transferee and the IRS). This is different from the way that basis consistency information is given to the IRS in all other circumstances; in other

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situations the IRS is advised with an “information return” (which is Form 8971), but in this situation both the IRS and recipient are advised using a Schedule A.

***How Will Recipient Know About Requirement To Report Subsequent Transfers?***

Perhaps the Notice on Schedule A should be revised by the IRS, or perhaps the transmittal letter sending a Schedule A to a beneficiary should notify the beneficiary that reporting requirements may exist with respect to certain subsequent transfers of property reported on the Schedule A.

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

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

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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time. Reporting to a beneficiary on a Schedule A that the 1,000 shares of Apple stock distributed to the beneficiary had a date of death value of \$X as reported on the estate tax return would be extremely misleading if the estate had actually sold 400 shares and later re-purchased 400 shares. (The cost basis of those 400 shares would be the purchase price at the time of the purchase, not the date of death value reported on the Form 706.)

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

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

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

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

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

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

This all begs the question of what exactly the attorney for the estate and the executor should be communicating to the beneficiary. In many estates, the executor will not have a fiduciary duty to the beneficiaries to whom Schedule A must be provided. One example is a joint tenant. An executor does not allow a fiduciary duty to the surviving joint tenant of property included in the decedent’s estate.

The executor may choose to send Schedule A to the beneficiary with a letter contextualizing the information reported on Schedule A and providing instruction on reporting subsequent carryover basis transactions. For estate attorneys and tax advisers, providing any information that could be construed as tax advice to non-client beneficiaries is a bad idea. This is leading some advisers to conclude that the optimal course of action is to simply tell beneficiaries to discuss the Schedule A with their tax advisor. Audrey Young, *The Consistency of Basis Rules and Other Post-Mortem and Gift Tax Developments*, 38<sup>th</sup> ANN. DUKE EST. PL. CONF. at 12 (Oct. 2016).

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

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

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

If the PR isn’t going to come to the office to sign the letter and 8971 so that we can complete the date for providing the Schedule(s) A and get them sent the same day, we send it all as a packet to the PR with instructions to sign the 8971, fill in the date for providing the Schedule A to each beneficiary, and mail the Schedule(s) A by certified mail to the beneficiaries the same date the date is filled in! Then, we have the PR send the original 8971 back to us so the attorney can sign the 8971 and send it all to the IRS, again by certified mail. When sending the packet to the IRS, we enclose a duplicate copy of the filing letter and the 8971 (without schedules) to be file-stamped and returned. (Grrr, it just irritates me thinking about how silly and complicated it is!)

We’re also fine if the PR wants to just sign the 8971 and have us fill in the providing date once the original 8971 gets back to us. He/she just has to tell us the date(s) the Schedule(s) A were mailed by certified mail to the beneficiaries!

Also, when we have more than one PR we do make all of them sign – we just have a separate signature page for each.

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

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

- k. **Revenue Impact; “Cracking Nuts With a Sledgehammer.”** Most planners are unaware of any situations in which beneficiaries have taken the position that the basis adjustment under §1014 is different than the value listed on the estate tax return. Many wonder if the revenue estimates (the Joint Committee on Taxation estimated a ten-year revenue impact of \$1.542 billion, and the 2016 Fiscal Year Plan

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estimated a \$3.237 billion revenue impact between 2016-2025) are realistic. (Perhaps the estimates assume there is substantial intentional cheating and that having basis numbers reported to the IRS will discourage cheaters.) Furthermore, will the additional actual revenue be less than the additional expense that will be incurred by estates in complying with the information reporting measures within 30 days after estate tax returns are filed? For large estates having various beneficiaries who cannot be funded by the due date of the reports, imagine the volume of reports that will be required when issuing “mini-Form 706’s” to each beneficiary. One wonders if the government’s revenue estimate takes into consideration that the additional expenses incurred by estates in complying with the reporting requirements will be deductible for estate tax purposes, resulting in an immediate estate tax savings. Most planners believe the revenue estimate is wildly overblown; one planner has referred to this basis consistency and reporting concept as “cracking nuts with a sledgehammer.” Dennis Belcher refers to it as “using a hydraulic press to crack hickory nuts.”

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

- a. **Overview.** The Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015 was released on July 31, 2015; it is available at [http://www.irs.gov/pub/irs-utl/2015-2016\\_pgp\\_initial.pdf](http://www.irs.gov/pub/irs-utl/2015-2016_pgp_initial.pdf). Two items from the 2014-2015 list for Gifts, Estates and Trusts were eliminated because of the issuance of final regulations: final regulations under §67 and the final portability regulations.

Four new items were included in the 2015-2016 Plan:

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

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

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

- “2. Guidance on definition of income for spousal support trusts under §682. [This projects addresses whether references to income in §682 refers to taxable income or fiduciary accounting income.]

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10. Guidance under §§2522 and 2055 regarding the tax impact of certain irregularities in the administration of split-interest charitable trusts." [This project will provide guidelines as to irregularities that are merely "foot faults" and those that have more serious consequences (and that may result in disqualification of the trust, under the reasoning of *Estate of Atkinson v. Commissioner*, 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002).]

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

"9. Regulations under §2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP [This could include, for example, the allocation of GST exemption to trusts created under a GRAT at the end of the initial GRAT term. This project first appeared on the 2012-2013 plan].

10. Final regulations under §2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008. [This item first appeared in the 2007-2008 plan.]"

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

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

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- Final regulations under §1022 will provide guidance to recipients of property acquired from decedents who died in 2010; there will likely be few changes from the proposed regulations that were issued in May 2015.
  - b. **Qualified Contingencies in Charitable Remainder Trusts, Rev. Proc. 2016-42.** Rev. Proc. 2016-42 addressed this item, providing a way for a CRAT to satisfy the difficult “probability of exhaustion” test by terminating before making an annuity payment that would cause it to fail the test, as discussed in Item 4.b.(4) of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).
  - c. **Using QTIP Trusts With Portability, Rev. Proc. 2016-49.** Rev. Proc. 2016-49 was issued September 27, 2016 to modify and supersede Rev. Proc. 2001-38 and clarify that portability can be used in connection with QTIP trusts. Rev. Proc. 2001-38 was intended to provide relief to estates that inadvertently made the QTIP election at the first spouse’s death when the election was not needed to reduce the estate tax. The new revenue procedure explains that with the amendment to the Code allowing portability elections, a deceased spouse’s estate may wish to elect QTIP treatment for property even when not necessary to reduce the estate tax liability, in order to leave a greater DSUE amount that could be utilized by the surviving spouse. The new procedure requires an affirmative election by the taxpayer seeking to nullify the QTIP election and generally treats a QTIP election as void only if (i) the federal estate tax was zero regardless of the QTIP election, (ii) no portability election was made, and (iii) the taxpayer follows specified procedural requirements to treat the QTIP election as void. For a discussion of the details of this procedure see Item 16.b below.
  - d. **Section 6166 Guidance.** The IRS is working on new comprehensive proposed regulations under §6166. A primary issue is the requirement of security in making a §6166 election, but the existing regulations will be restated and replaced with new regulations.
  - e. **Closing Letters.** In a June 16, 2015 update to the “Frequently Asked Questions on Estate Taxes” on the IRS website, the IRS indicated that for all estate tax returns filed on or after June 1, 2015, estate tax closing letters will be issued only upon request by the taxpayer. Taxpayers are asked to wait at least four months after filing the estate tax return to make the closing letter request “to allow time for processing.” Apparently, this change in procedure is made in light of cuts to the IRS budget and in light of the fact that a closing letter does little good for returns filed solely to elect portability (because the statute of limitations on that return for determining the DSUE amount does not lapse until the statute of limitations lapses on the surviving spouse’s return). Estates that owe estate taxes will almost routinely want to request the closing letter before making estate distributions.

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

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

Some practitioners have had great difficulty in becoming qualified to access and in accessing the account transcript for an estate. Many hours and frustrating phone calls have sometimes still not resulted in being to access the transcript. For a (rather humorous) description of one practitioner’s attempts to complete the 17-step process of registering on the IRS’s TDS system to request account transcripts online, see Item 2.g.(2) of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).

- f. **Inflation Adjustments for 2016, 2017.** Revenue Procedures 2015-53 and 2016-55 describe inflation adjustments for 2016 and 2017, respectively. Some of the adjusted figures include the following:
- Individual income tax brackets: The top bracket for married individuals begins at \$466,950 of taxable income in 2016 and \$470,700 in 2017; the top bracket for single individuals begins at \$415,050 of taxable income in 2016 and \$418,400 in 2017;
  - Estate and trust income tax brackets: The top bracket begins at \$12,400 of taxable income in 2016 and \$12,500 in 2017;
  - Transfer tax exemption amount: The basic exclusion amount (i.e., the estate, gift, and GST “exemption” amount) is \$5,450,000 in 2016 and \$5,490,000 in 2017;
  - Annual exclusion: The gift tax annual exclusion remains at \$14,000 in 2017, but will likely go to \$15,000 in 2018 (the indexed annual exclusion number increases only in increments of \$1,000 does not “round up,” and if it were rounded up to the nearest \$100, it would have been \$14,500 in 2014, \$14,700 in 2015, \$14,800 in 2016, and \$14,900 in 2017 [these numbers are 1/10<sup>th</sup> of the indexed number for the non-citizen spouse gift amount, described immediately below]); and
  - Gifts to non-citizen spouse: The first \$148,000 of present interest gifts in 2016 and \$149,000 in 2017 to a non-citizen spouse are excluded from taxable gifts.



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- g. **GST Trust Modification Rulings Suspended.** Cathy Hughes (with the Treasury Department) has announced beginning in the fall of 2016 that the IRS is temporarily suspending considering GST rulings for trust modifications until further notice. This was not added to the “no-rule” list in Rev. Proc. 2017-3 because it is not a permanent change. The reason for this change is that the IRS does not have sufficient resources to continue considering these requests, which are often accompanied by a huge stack of documents. Requests that have been filed before this change of policy will still be considered; future submitted requests will be returned.
- h. **Same-Sex Marriage; Notice 2017-15 Allowing Recovery of Applicable Exclusion Amount and GST Exemption Allocation.** Rev. Rul. 2013-17 clarified that for federal tax purposes (1) terms relating to marriage include same-sex couples, (2) a place of celebration standard is applied if a same-sex couple moves that a state that does not recognize same-sex marriages, and (3) the ruling does not apply to domestic partnerships or civil unions. It is applied prospectively as of September 16, 2013 (the date of the ruling’s publication) but taxpayers may (but need not) file back returns within the standard limitations period for refunds if the recognition of the marriage results in lower taxes. In effect, the IRS implicitly acknowledged the retroactive application of unconstitutionality of the Federal Defense of Marriage Act (“DOMA”). See also Treas. Reg. §301.7701-18 (definition of “husband and wife” as meaning “two individuals lawfully married to each other”).

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

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

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

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

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

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## 6. Section 2704 Proposed Regulations

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

Section 2704(a), titled “Treatment of Lapsed Voting or Liquidation Rights,” treats certain lapses of voting or liquidation rights as deemed transfers if the family controls the entity both before and after the lapse. (In *Estate of Harrison v. Commissioner*, T.C. Memo. 1987-8, the decedent owned all of the limited partnership interests and a small general partner interest in a limited partnership. As a general partner, the decedent could liquidate the partnership, but a general partner’s right to liquidate the partnership lapsed at the partner’s death. The court held that the estate tax value of the decedent’s partnership interests did not include the value attributable to the right to compel liquidation of the partnership.)

Section 2704(b), titled “Certain Restrictions on Liquidation Disregarded,” provides that any “applicable restriction” is disregarded in valuing an interest in a corporation or partnership that is transferred to a family member if the transferor and family members control the entity. An “applicable restriction” is any restriction that (i) effectively limits the ability of the corporation or partnership to liquidate, and (ii) the restriction lapses (entirely or partially) after the transfer OR the transferor or family members can remove the restriction (entirely or partially), but an “applicable restriction” does not include “any restriction imposed, or required to be imposed, by any Federal or State law” (or commercially reasonable restrictions imposed by unrelated persons in a financing transaction). Regulations interpreted the “imposed, or required to be imposed, by Federal or State law” exception to mean that default restrictions on the ability of an owner to withdraw from an entity could be considered, even though the family could have overridden those restrictions in the governing documents. Many states have a default rule limiting the ability of a limited partner or member of an LLC to withdraw, and the IRS has stated that the default rule in the regulations has made §2704(b) rather toothless.

Section 2704(b)(4) gives the IRS the authority to provide in regulations that other restrictions may similarly be disregarded in valuing transfers of interests in the entity if the restriction merely reduces the value for transfer tax purposes but does not ultimately reduce the value of the interest for the transferee.

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

The IRS on August 2, 2016 released long-awaited proposed regulations under §2704 (published in the Federal Register on August 4, 2016). These proposed regulations generally implement the provisions of a proposal (included in the Obama Administration’s budget proposals submitted in 2009-2012) to amend §2704 legislatively. (The administration removed the proposal in the Fiscal Year 2014 budget proposal after no bills were ever introduced to enact the proposal. See Item 5.m.(16) of the Current Developments and Hot Topics Summary (December 2016) found [here](#)

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and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor) for a summary of the legislative proposal).

Very importantly, the proposed regulations are not effective until they are finalized (or for some provisions, until 30 days after they are finalized). A new “three-year rule” might apply, however, to transfers made before the effective date if the transferor dies after the effective date but within three years of making the initial transfer.

Major provisions of the proposed regulations include:

- *Covered Entities.* Covered entities are defined broadly (for example, including LLCs regardless of whether they are disregarded as separate entities for federal tax purposes), to include LLCs, and control rules are described for various types of entities.
- *Assignees.* Transfers to assignees may result in lapsed liquidation or voting rights under §2704(a) and will be subject to the “disregarded resections” rules.
- *Deaths Within Three Years.* Transfers that result in the transferor losing a liquidation right may be subject to a three year rule, requiring inclusion of the liquidation value in the transferor’s gross estate at death if the transferor dies within three years of the transfer. The phantom value included in the gross estate (generally speaking, the value attributable to being a minority interest or being less than the percentage ownership required to force the liquidation of the entity) would not qualify for the marital or charitable deduction. The three-year rule may be the most important part of these proposed regulations – creating a risk that the minority discount for lifetime transfers may be added into the donor’s gross estate if the donor dies within three years.
- *State Law Default Restrictions Not Considered.* Default restrictions under state law (such as withdrawal restrictions that can be overridden by the family) can no longer be considered in valuing transferred interests that are subject to §2704(b).
- *Disregarded Restrictions.* A potentially far-reaching part of the proposed regulations is the creation of a new category of “disregarded restrictions.” Some commentators have viewed these provisions as effectively valuing transfers of interests in family-controlled entities as if the holder of the interest has a put right to sell the interest to the entity within six months for a value at least equal to a pro rata part of the net value of the entity in return for cash or property (but not notes except in certain situations). The more likely view, expressed by other commentators, is that the disregarded restrictions category is much narrower, simply disregarding *explicit* “restrictions” limiting an owner’s redemption of its interest in the entity to an amount that is less than a pro rata part of the net value of the entity or for which payment can be made in other than “cash or property.” Government officials have confirmed that the more restrictive interpretation was intended, and that there was no intent to eliminate typical minority and marketability discounts.
- *Unrelated Parties Generally Not Recognized for Removal of Disregarded Restrictions By Family Test.* In determining whether the family can remove “disregarded restrictions,” the interests of unrelated parties are not considered

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unless unusually stringent conditions are satisfied (which usually will not be the case).

- *Commercially Reasonably Restrictions for Active Business Entities.* In light of the very broad scope of the application of the new provisions, a “commercially reasonable restriction” exception for entities with trade or business operations may become important.
  - *Marital and Charitable Deduction.* Values will generally be applied consistently for both estate inclusion and for deduction purposes (for the marital deduction and charitable deduction).
- b. **Effective Date.** The proposed regulations are NOT effective immediately. They apply only to transfers made after final regulations are promulgated, and the new category of “disregarded restrictions” only apply to transfers made at least 30 days after the regulations become final (because under the Administrative Procedures Act, “legislative regulations” making substantive changes cannot become effective until at least 30 days after they are issued). Prop. Reg. §§25.2701-8, 25.2704-4(b)(1)-(2). Government officials have confirmed that the regulation will be revised to clarify that the three-year rule will only apply to transfers made after the final regulations are issued.
- c. **Hearing for Comments to IRS/Treasury; “On the Record” Comments by IRS/Treasury.** More than 10,000 comments were submitted to the IRS about the proposed regulations (many of them from small business owners criticizing the application of the proposed regulations to active ongoing business entities.) A hearing was held on December 1, 2016 to consider public comments. More than three dozen people delivered comments to four Treasury and IRS panelists. The Government officials emphasized “on the record” that there was no intention to make the three-year rule retroactive to transfers made before the final regulations are issued, and that the regulations were not intended to require that interests be valued as if a deemed put right exists. (Various planners have pointed out that how a judge, IRS auditor, or field agent interprets the regulations is what really matters.)
- d. **Detailed Discussion of Proposed Regulations.** For a detailed discussion of the substantive provisions of the proposed regulations, see Item 5.c-l of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).
- e. **Planning Implications.**
- (1) **Firestorm Over Proposed Regulations; Unlikely to Be Finalized During a Republican Administration.** The proposed regulations have spawned a firestorm of responses. A Wall Street Journal editorial referred to the proposed regulations as “A Stealth Death Tax Increase.” WALL ST. J. (Sept. 5, 2016). Various bills were been introduced in 2016 an attempt to negate the proposed regulations. *E.g.* H.R. 6042 (providing that the proposed regulations “and any substantially similar regulations hereafter promulgated, shall have no force or effect”); H.R. 6100 and S.B. 3436 (blocking funding for completion of the proposed regulations or similar guidance) Rep. Davidson (R-Ohio) and Sen. Rubio (R-Fla.) have reintroduced those bills in the current Congress as H.R. 308 and S. 47.

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Statements from the Treasury and the Obama administration to the effect that the proposed regulations “close a tax loophole” that certain taxpayers have used to undervalue assets for estate and gift tax purposes and “that allows some wealthy families to avoid paying their fair share in estate taxes” have fueled a belief that the proposed regulations significantly reduce lack of control and marketability valuation adjustments, producing the firestorm of reactions to the proposed regulations.

In light of the election of President Trump and having a Republican controlled House and Senate, the likelihood that these regulations will be finalized appears extremely remote at least as long as a Republican Administration gives direction to Treasury. Especially in light of the firestorm that has erupted over these proposed regulations, a Republican administration is likely not going to finalize these regulations. When Treasury Secretary Mnuchin, when asked if he would consider withdrawing the proposed regulations, responded:

Absolutely. I will tell you that both I and the President-elect believe in appropriate regulation. And specifically, on what you’ve mentioned, on the IRS regs on family businesses, I am committed to working with you and your office—we want to make sure that we cover the appropriate loopholes, so that if people have businesses set up to avoid taxes it’s one thing—and they’re not real operating business. But any operating business we need to make sure that people who own minority interests in operating businesses that the valuation for tax purposes are reflected appropriately.

Even in the extremely unlikely event that the IRS could have finalized these regulations before the new President took office on January 20, 2017, the regulations could have been overturned by Congress under the Congressional Review Act of 1996 (not subject to filibuster in the Senate) as long as the Congressional action occurs within 60 “legislative days” of the finalization date. (The counting does not necessarily start when the rule is published in the Federal Register, but when a “report” of the rule is delivered to Congress. See Kimberley Strassel, *A GOP Regulatory Game Changer*, WALL ST. J. at A-13 (Jan. 26, 2017).)

(2) **Continuing Significance.** Even though the proposed regulations almost certainly will not be finalized and issued as final regulations during the Trump Administration, they are not totally dead. This has been an ongoing project with the IRS since the 2003-2004 Priority Guidance Plan. Some have referred to these as the “Lazarus” regulations because “they will rise again.” Presumably, these regulations will be dusted off and the IRS will continue its work on the regulations when a Democrat serves as President.

In light of the significant adjustments that will be required in the regulations, various comments were filed requesting that the regulations be re-issued as another round of proposed regulations to allow public comment. The American Institute of Certified Public Accountants filed comments with the IRS on January 13, 2017, which began with a recommendation that the proposed regulations be formally withdrawn, or if that is not done, that the IRS “issue new, clarified proposed regulations for public comment.”

(3) **Active Trade or Business.** Planners have speculated about whether the new regulations would focus on entities holding passive investment assets rather than

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active trade or business entities. The regulations apply similarly to both, however. The only concessions for trade or business entities are (i) the ability of the entity or owners to use a note to pay the redemption proceeds on exercise of the six-month put right, and (ii) the availability of the “commercially reasonable restrictions” exception that applies only to trade or business operations.

The IRS has received a number of comments requesting that an exception be provided for active businesses. (The valuation provision proposed by the Clinton administration restricting discounts several decades ago would only have applied to passive assets, not active business interests.) The AICPA comments filed with the IRS on January 13, 2017, among other things, recommends applying the

regulations only to entities that do not carry on an active trade or business, or at a minimum, not applying the final regulations to the extent an entity’s assets are used in the active conduct of a trade or business ... There are valid, non-tax reasons for the restrictions that exist in the operating agreements of these operating businesses that Treasury and the IRS will subject to the proposed regulations. The proposed regulations would place an undue financial burden on these family businesses.

For purposes of determining whether an entity carries on an active trade or business, we recommend that Treasury and the IRS consider a business as “active” if it generates expenses that are deductible pursuant to section 162.

Government officials have indicated that an exception for active businesses was not included because no such distinction exists in the statute, and because of the difficulty of defining what entities and assets would qualify for the exception – pointing to the difficulties in applying the “trade or business” requirement under §6166. Ron Aucutt’s reaction: “Write your own rules rather than relying on §6166. No one will criticize you if you overstep a little.”

Cathy Hughes (with the Treasury Department’s Office of Tax Policy) hinted at the Heckerling Institute that they will continue to look at this issue (along with the other comments) and determine if a workable distinction can be developed. At the ABA Tax Section meeting on January 20, 2017, Ms. Hughes reiterated that Treasury is looking into adding a business exemption, which “would make most of the objections to these proposed regs go away.” That was one of the big points from the hearing about the proposed regulation “so we will take that into consideration.” She confirmed that the IRS had decided not to use the §6166 definition, “because 6166 is a mess.”

(4) **Gifts or Sales Before Effective Date; Adequate Disclosure Requirements.** For gifts or sales that are made after the regulations were proposed (released on August 2 and published on August 4, 2016), return preparers making disclosures of the transactions may consider disclosing that the valuation does not consider the impact of the proposed §2704 regulations, in light of the fact that the regulations do not apply to transfers made before the regulations are finalized. The adequate disclosure general rule is that the transfer must be “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). The regulation goes on to provide a 5-part safe harbor test under which transfers “will be considered adequately disclosed,” the last item of which is “[a] statement describing any position taken that is contrary to any

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proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer ....” If the return preparer wishes to comply with the safe harbor, the statement could be as simple as “The section 2704 proposed regulations were not taken into account in determining the reported value.” A statement in an appraisal attached to the return stating that the §2704 proposed regulation was not considered should also suffice. In addition, the planner may wish to add that whether the valuation is inconsistent with the proposed regulations cannot be determined based on the ambiguity in the proposed regulations, and that the valuation is likely consistent with the proposed regulations, assuming that the regulations are interpreted to describe as “disregarded restrictions” only express prohibitions or restrictions on the ability of the entity to redeem the owner’s interest in the entity.

Stephanie Loomis-Price (Houston, Texas) suggests the following as a possible disclosure:

The appraisal included at Tab \_\_\_ considers restrictions included in the entity’s governing agreement and applies discounts for lack of marketability and lack of control that might have triggered the application of Section 2704 under the Proposed Regulations issued on August 2, 2016, had those Proposed Regulations (in their current form) been promulgated on or before the date that the transfer occurred.

The AICPA website has a recommendation for making such a disclosure. It recommends something similar to the following suggested disclosure statement:

Disclosure under Treasury Regulation § 301.6501(c)-1(f)(2)(v)

The transaction at issue may be contrary to the section 2704 proposed regulations. However, the section 2704 proposed regulations have not been taken into account in determining the fair market value of the interest [describe interest] because, under the effective date provision of the section 2704 proposed regulations, there is no requirement that the section 2704 proposed regulations be considered or applied in this case.

**(5) Current Transfers to Relinquish Liquidation Rights; Unwinding Partnerships.** If an owner holds enough interest in an entity to force the liquidation of the entity, consider making a transfer of a sufficient interest before the regulations are finalized so that the owner no longer holds a sufficient interest to force the entity’s liquidation. (For example, if state law provides that a corporation will be liquidated on the vote of two-thirds of the shareholders and the owner holds 80% of the stock, consider transferring at least 14% of the stock so that the owner will hold less than two-thirds of the vote.) As long as no voting rights for that 14% are eliminated, §2704(a) will not apply and the three-year rule will not apply under the current regulations.

Alternatively, the owners might amend the governing documents before the regulations are finalized to provide that a unanimous vote of owners would be required to force the liquidation of the entity. Section 2704(a) should not apply to that amendment because no rights associated with any ownership interests are eliminated as a result of the amendment (i.e., no voting rights are eliminated). Any owners holding less than all of the ownership interests could then make future transfers without risk that the new three-year rule of §2704(a) would apply.



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Avoiding the three-year rule may be an additional impetus for an owner to get rid of the general partner interest in a limited partnership (in addition to avoiding the potential §2036(a)(2) risk). Getting rid of the general partner interest before the regulation is finalized would avoid the three-year risk that would apply if the holder gets rid of the general partner interest after the regulation is finalized.

For new entities being created, perhaps a trend will emerge toward requiring unanimous consent of owners to liquidate to avoid the three-year rule for future transfers.

Because the regulations will likely not be finalized for years to come, this planning alternative will not be a high priority for many clients. But if the client does not have strong feelings about holding an ownership interest above the level that allows the owner to liquidate the entity, the transfer may prove helpful once the regulations are finalized if they continue to contain the new three-year rule.

(6) **Other Detailed Planning Implications.** In light of the fact that the proposed regulations will likely not be finalized for years to come, planning implications of the proposed regulations have been minimized in this summary. For a more complete discussion of various planning implications (including a discussion of the validity of the regulations in light of the statute and legislative history and a comparison of the proposed regulations with the legislative proposal to amend §2704 that was contained in the President's 2010-2013 Fiscal Year Budget proposals), see Item 5.m of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).

## 7. Placebo Planning - Dispelling Common Transfer Planning Myths

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

- a. **Saving Tax on the Appreciation.** And often stated maxim of the advantage of the estate freezing is that "any future appreciation will not be includable in the estate." That maxim is incorrect to the extent that it suggests that an advantage results from paying an upfront tax in order to avoid estate tax on the appreciation. With a flat tax, whether the transfer tax is incurred currently at a low value or later at a higher value makes no difference.
- b. **Savings From Grantor Paying Income Tax on Grantor Trust.** The grantor's payment of income tax on grantor trust income, without that payment being treated as a gift, is often stated as a key advantage of grantor trusts. That factor alone, however, is not significant. For example, the donor can give \$2,000 to a trust, which produces \$100 annually. The donor's income tax on that \$100 is \$40. The trust receives \$100 free of income tax and the donor pays \$40 of income tax. Alternatively, the donor could keep the \$2,000 of income-producing corpus and receive the \$100 each year, paying the \$40 of income tax, and giving \$100 to the donee. In each case, the donee receives \$100 income tax-free, and the donor pays \$40 of income tax.

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

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

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

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

- e. **Credit Shelter Trust vs. Portability at First Spouse’s Death.** Three scenarios are compared for planning alternatives at the first spouse’s death: (1) portability, (2) optimal marital/credit shelter trust, and (3) attempting equalization by accelerating tax at the first death. Examples show that if assets values do not change between the spouses’ deaths, all three approaches generate the same result. If the assets increase in value, the portability plan is not as effective as the other two scenarios. If assets depreciate during the “over life” of the surviving spouse, the portability alternative is better.
- f. **Allocation of Exemption in a Carryover Basis World.** If the estate tax is repealed with carryover basis, and if some amount of exemption can be added to the basis of assets at the election of the estate, how should the exemption be allocated? Jeff concludes that the exemption should be allocated to assets that are intended to be sold first. An exception is if assets are subject to depreciation, deduction, or depletion. Allocating basis to those assets permits a new round of current depreciation/depletion deductions (against ordinary income tax). An even better result occurs for assets that would also be subject to recapture.

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

## 8. Structuring Trusts For Flexibility

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

- supplemental needs trust,
  - substance abuse,
  - decanting,
  - trustee appointment and succession,
  - trust protector powers,
  - release of protected health information to trust protector,
  - directed trust and divided trusteeship (with detailed powers of an investment trustee and powers of a distributions trustee),
  - savings clause negating power of appointment for interested trustee as beneficiary,
  - maintenance of real or personal property and permitting beneficiaries to use such property,
  - apportionment of receipts and disbursements,
  - S corporation stock,
  - closely held business interests,
  - farm or ranch property,
  - Crummey withdrawal rights,
  - authority to make charitable distributions,
  - grantor trust trigger powers (including substitution power and power to compel trustee to loan without adequate security),
  - retirement benefits provisions (including conduit trusts and accumulation trusts),
  - changing situs and governing law,
  - powers of appointment (including formula general powers of appointment and exercise of powers to “trigger” the Delaware tax trap),
  - unitrust distributions, and
  - treating capital gain as part of DNI.
- a. **Flexibility to Distribute Income to Charity.** For an excellent discussion of charitable contributions by trusts or estates, see Jonathan Blattmachr, F. Ladson Boyle & Richard Fox, *Planning for Charitable Contributions by Estates and Trusts*, 44

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EST. PL. (Jan. 2017). Authorizing discretionary charitable distributions can provide very helpful flexibility.

(1) **Advantages.** The ability of a trust to make charitable contributions has several distinct advantages compared to individual charitable contributions. (i) Trusts do not have percentage limitations on the charitable deduction, but §642(c) allows an unlimited deduction. (However, the percentage limitations under §170 apply to a trust to the extent the gross income that is paid to charity consists of unrelated business income. The trust should direct that payments come first from gross income that is not unrelated business income, though it is not clear that restriction would be respected for tax purposes.) (ii) A trust is entitled to a charitable deduction for the year in which the income is paid for charitable purpose even if the income was earned in prior years. (iii) If a payment of gross income to charity is made in the year after it is earned, the trust may elect under §642(c)(1) to treat the payment as having been made in the preceding year in which the gross income was earned. (iv) A trust (unlike individuals) can reduce its net investment income subject to the 3.8% tax by charitable deductions. (v) The cut-back on deductions under §68 does not apply to estates or trusts. (vi) If future legislation imposes overall monetary limits on deductions (as proposed by President Trump), those same limitations may not be imposed on trusts.

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

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

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

If the trust does not authorize charitable distributions, consider (i) decanting the asset to another trust that grants a power of appointment to someone to appoint assets to charity (but whether that is effective is not clear because the charitable intent might arguably have to come from the creator of the original trust), or (ii) contributing assets

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to a partnership which in turn makes contributions to charity from its gross income. See Rev. Rul. 2004-5; Jonathan Blattmachr, F. Ladson Boyle & Richard Fox, *Planning for Charitable Contributions by Estates and Trusts*, 44 EST. PL. (Jan. 2017).

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

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

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

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

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

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

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

The Trustee is authorized to determine what is principal and income of the trust estate and what items shall be charged or credited to either. In making these determinations, the Trustee shall act reasonably and treat the beneficiaries impartially consistent with the Trustee's fiduciary duties, and the Trustee may not exercise these powers in any way that departs fundamentally

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from traditional principles of income and principal within the meaning of Treasury Regulations 1.643(b)-1. No inference of imprudence or partiality shall arise solely because the Trustee exercises the Trustee's discretion to determine what is principal and income in a manner that deviates from default rules of law that arbitrarily allocate fixed percentages of receipts to principal and income. (Clause by Steve Trytten)

- d. **Unitrust Definition of Income.** For instruments that require mandatory income distributions (such as QTIP trusts), consider using a unitrust definition of income. With that approach all beneficiaries have an interest in the trust investing in a manner that will maximize the security and growth of the trust. Consider the following with a unitrust clause:
- use a two or three-year rolling average so that valuation swings will not disrupt distributions dramatically;
  - discuss how to value hard-to-value assets; and
  - if the trustee allows a beneficiary to use residential property, provide that the value of the residence shall be excluded in determining the unitrust amount. (The beneficiary's rent-free use of the property is not income to the beneficiary, as discussed immediately below.)
- e. **Use of Trust Property by Beneficiary.** Merely allowing a beneficiary to use trust assets, even if the trust pays property taxes or maintains the asset, is not a distribution that carries out DNI to the beneficiary. *duPont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976), *aff'd* 574 F.2d 1332 (5th Cir. 1978); *Commissioner v. Plant*, 76 F.2d 8 (2d Cir. 1935), *acq.* 1976-1 C.B. 1; Ltr. Rul. 8341005.

**Sample Clause:**

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

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

**Sample Clause:**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Notwithstanding any contrary provision, I may reacquire any of my grantor property from any trust created under this instrument by substituting other property of an equivalent value. For purposes of the preceding, my "grantor property" means the property (or portion of property) with respect to which I am the grantor for federal income tax purposes. I may irrevocably release this power in whole or in part by notice to the Trustee. I may exercise (or release) this power: (i) in a non-fiduciary capacity and without the consent of any person; and (ii) through a duly appointed guardian or a duly authorized attorney-in-fact. I hold this power in a non-fiduciary capacity, and may exercise it without the approval or consent of the Trustee or any other person.



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However, the Trustee, acting in a fiduciary capacity shall have a duty to ensure that the property substituted has equivalent value, and to that end, shall provide me with sufficient information regarding the assets of the trust to enable a suitable valuation of the assets to be performed. I intend that the trusts created under this instrument constitute "grantor trusts" for income tax purposes under the Code whenever (and to the extent that) this power exists but not otherwise; this instrument shall be administered and interpreted in a manner consistent with this intent and any provision which conflicts with this intent shall be deemed ambiguous and shall be construed, amplified, reconciled, or ignored as needed to achieve this intent. (Clause by Mickey Davis.)

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

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

General guidelines for maximizing flexibility include the following:

- whoever has a substitution power should be given the authority to release the power and bind future persons (thereby terminating grantor trust status permanently, if desired);
- if the grantor holds the trigger power, the grantor can be given the ability to relinquish the power (to the extent provided in the trust agreement) and therefore terminate grantor trust status;
- an agent for the grantor under a power of attorney should have the authority to relinquish the trigger power;
- consider using a temporary release of the power such as, for example, giving up the swap power during 2017 (the relinquishment would apply prospectively and not back to the beginning of the year); that approach would cause the trust to again become a grantor trust in 2018, unless the swap power is released again;
- use different persons to have the right to relinquish or reacquire the power;
- an adverse or non-adverse party could hold the power to relinquish and reinstate the grantor trust power (but note that if the grantor's spouse has the power to relinquish and to reacquire the grantor trust power, the grantor would be treated as holding the power to reacquire the grantor trust power [under §672(e)] and grantor trust status arguably would not be cut off by relinquishment of the power causing grantor trust status);

- giving different persons the authority to exercise those powers, to relinquish them, or to reacquire them, may provide useful checks and balances of the ability to misuse those powers;
- the relinquishment of the grantor trust power should address whether it binds successors, and in any event only permit reinstatement in a subsequent year to assure that the trust remains a grantor trust for the balance of the current year; and
- methods of reinstating grantor trust status if the trust agreement does not authorize reinstatement of a trigger power include (i) decanting the trust into another trust that has a grantor trust trigger power, or (ii) merging the trust under state law merger provisions with another trust that has a grantor trust trigger power.

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

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

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

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

- l. **Trusts as Beneficiaries of Retirement Plans – See Through Trusts.** If a trust is a beneficiary of a retirement plan, benefits can be paid over the lives of the beneficiaries only if the trust qualifies as a “see-through” trust: either a conduit trust (required to pay all retirement plan distributions to the beneficiary), or an accumulation trust meeting rigid requirements (in which event the payments can be made over the life expectancy of the oldest beneficiary). Broad powers of

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appointment are problematic with an accumulation trust, because possible appointees may include very elderly individuals, whose short life expectancies would become the limit on being able to “stretch out” distributions from the plan.

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

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

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

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

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

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

- a mandatory general power of appointment provision;
- a formula general power of appointment provision (which may use formula provisions to describe the value of assets and order the types of assets [such as appreciated assets] over which the power is exercised);

- an authorization for some third party to grant a general power of appointment to the beneficiary; or
- the exercise of a limited power of appointment by the beneficiary in a manner that will trigger the “Delaware tax trap,” which is generally accomplished by exercising the power to create a trust in which some other person has a presently exercisable general power of appointment (which extends the perpetuities period for the trust, thus triggering §2041(3)). A statute in Arizona permits triggering the Delaware tax trap by exercising a limited power of appointment to create another *limited* power of appointment in another individual in a certain manner (which avoids the problem of having to “stick” some person with the imposition of a general power of appointment (causing estate inclusion and potential creditor problems for that person)).

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

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

**Exercise of Powers of Appointment.**

- A. Identification of Power.** Under the Last Will and Testament of my deceased [spouse] dated \_\_\_, (“my [spouse]’s Will”) the \_\_\_ Trust (the “Trust”) was created for my primary benefit. Pursuant to Section \_\_\_ of my [spouse]’s Will, I have a Testamentary Power of Appointment to appoint all of the remaining property of the Trust (outright, in trust, or otherwise) to any one or more of my [spouse]’s descendants.
- B. Exercise of Power.** I hereby appoint the property described in Subsection C below to my children who survive me, in equal shares. However, if any child fails to survive me but leaves one or more descendants who survive me, I give the share that child would have received (if he or she had survived) per stirpes to his or her descendants who survive me. All of the preceding distributions are subject to the provisions of Article \_\_\_ (providing for lifetime Descendant’s Trusts [*that grants the primary beneficiary thereof (or others) a presently exercisable general power of appointment*] for my children and other descendants).
- C. Extent of Exercise.** The foregoing exercise does not apply to the following assets held by the Trust: (i) cash or cash equivalent accounts (such as savings accounts, certificates of deposit, money market accounts or cash on hand in any brokerage or equivalent accounts); (ii) property that constitutes income in respect of a decedent as described in Code Section 1014(c); (iii) any interest in any Roth IRA accounts or Roth variants of other retirement plans, such as Roth 401(k)s, 403(b)s, 457(b)s, and the like; and (iv) any interest in any property that has a cost basis for federal income tax purposes that is greater than or equal to the fair market value of the property at the time of my death (the “Excluded Assets”). If, after eliminating the Excluded Assets, the inclusion of the value of the other assets in the Trust in my taxable estate for federal estate tax purposes would not increase the federal estate and state death taxes payable from all sources by reason of my death, this power of appointment shall apply to all remaining assets of the Trust other than the Excluded Assets (the “Included Assets”). However, in the event that the inclusion of the value of all of the

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Included Assets in the Trust in my taxable estate for federal or state estate or inheritance tax purposes would increase the taxes so payable, the assets of the Trust appointed by this Section shall be further limited as follows: The Trustee shall for each of the Included Assets evaluate the ratio of the fair market value at the time of my death to the cost basis immediately prior to my death first (the "Gain Ratio"). The Trustee shall thereafter rank the Included Assets in order of their respective Gain Ratio. The appointment shall apply first to the Included Asset with the largest Gain Ratio, and thereafter in declining order of Gain Ratio to each of the subsequent Included Assets; however, at such point that inclusion of the next in order of the Included Assets would otherwise cause an increase in my estate's federal or state estate tax liability as described above, my appointment pursuant to this Section \_\_\_ shall be limited to that fraction or percentage of that Included Asset that will not cause any federal or state estate tax liability, and all lower-ranked Included Assets shall be excluded from the exercise of this power of appointment.

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

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

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

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

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

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

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

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

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

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

Developed law exists in Delaware regarding directed trusteeships. State statutes are becoming more complete and thoughtful regarding directed trusteeships, such as in Missouri (see §808 of its Uniform Trust Code) and Alaska, among others. See RESTATEMENT (THIRD) OF TRUSTS §75; UNIF. TRUST CODE §808. The Uniform Law Commission has a project to develop a Uniform Directed Trust Act, expected to be completed in the summer of 2017. The discussion draft discussed in July 2016

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provides that a directed trustee has no liability when acting at the direction of the adviser absent willful misconduct by the directed trustee, and has no duty to monitor the adviser. Be careful with the jurisdiction being selected if a directed trust relationship will exist.

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

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

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

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

- r. **S Corporation Stock.**

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

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

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

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

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

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

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



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### **Sample Clause:**

The following paragraphs apply upon the death of the beneficiary of a trust with respect to which a QSST election is in effect immediately before the beneficiary's death, if and to the extent not overridden by a power to Appoint:

(1) If the individuals to whom the S corporation stock is allocated do not share in the residue of the deceased beneficiary's estate (in this or Agreement, Article \_\_\_ determines the sharing of the residue of my estate, because my will bequeaths my estate to the Revocable Trust and Article \_\_\_ bequeaths the residuary trust assets), then any distributions the S corporation makes to pay its shareholders' taxes with respect to their distributive shares of taxable income before the date of death shall be treated as income earned before the beneficiary's death and paid to the beneficiary's revocable trust entitled to the residue of the beneficiary's estate, if any, otherwise to the beneficiary's estate.

(2) If and to the extent that paragraph (1)\_\_\_ does not apply, during trust administration, after the beneficiary's death and before separate trusts can be funded, the trust will not terminate but rather will continue as a single trust with separate shares pursuant to U.S. Treas, Reg. section 1.1361-1(j)(9)(ii), Example (1), Section \_\_\_ shall not apply, and the trusts for the beneficiaries will be amended under paragraphs (1)\_\_\_, (2)\_\_\_, and (3) of subsection (A)\_. (Clause by Steve Gorin.)

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

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

### **Sample Clauses.**

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

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

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

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

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

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

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

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

- b. **Prenuptial Agreements.**

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

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

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

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

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

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

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

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

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

- c. **Trusts – Trend Toward Longer and More Discretionary Trusts.** Several decades ago, many trust instruments tended to terminate at ages 25, 30 and 35 for beneficiaries. Later, a trend developed to leave assets in trust allowing the children to withdraw after certain ages. An emerging trend is to suggest distributions that might be made at certain ages, but provide that distributions are totally discretionary with the trustee. Long-term sprinkling dynasty trusts, perhaps with totally discretionary distributions, are becoming more normal. This trend reflects, in part, an increasing concern with "predator protection."
- d. **Traditional Spendthrift Principles.** Under traditional trust law principles, trust assets will be more protected from claims of creditors of beneficiaries if the trust is a pure discretionary trust (rather than having ascertainable standards for distributions) and if the beneficiary is not the trustee (at least with a discretionary trust). In addition, spendthrift provisions provide protection against a beneficiary's creditors, but many states have adopted "exception creditors" including claims for child support and alimony that may reach trust assets despite the spendthrift provision.

**UTC – Spendthrift Clause.** Under the Uniform Trust Code, a spendthrift clause protects against a beneficiary's general creditors (§502(c)), but does not protect against exception creditors (including a spouse, child, a former spouse who has a judgment against the beneficiary for support or maintenance and certain others) (§503(b)). Exception creditors may obtain a court order attaching present or future distributions to or for the benefit of the beneficiary, which the court may limit as appropriate under the circumstances. §503(c). For support trusts (with a standard

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for distributions that is *not discretionary*), a creditor apparently can seek to have a court compel the trustee to make a distribution under the distribution standard. *Cf.* §504(b) (trustee of *discretionary* trusts generally cannot be compelled to make distributions, whether or not a spendthrift clause applies).

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

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

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

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

- e. **Increasing Attacks on Trusts in Divorce Proceedings.** The scenario described above with a trust beneficiary who has substantial control over the trust and who does not respect the trust also applies in the divorce context. The divorce judge in a

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court of equity is looking for equity and fairness and may be even more inclined than a judge in the traditional tort context to reach (or at least consider) the trust assets that are available to one of the spouses. Family lawyers are taking CLE courses about how to find assets in trusts and how to attack trusts. A case in Hong Kong awarded \$1 billion of assets from a trust in a divorce matter. Bruce Stone warns: "Take off your trust and estate hat when you venture into this divorce area. It is a different world. They think differently. The rules are different." Scott Rubin (family lawyer in Miami, Florida) adds that "in the family lawyer's world, a living trust is always revocable."

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

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

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

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

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

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

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

- h. **Drafting Considerations.**

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

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

**Sample Clause (by Bruce Stone):**

*Restrictions Applicable to a Married Beneficiary*

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

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

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

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

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

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

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

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

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

1.3(c) If a beneficiary's spouse executes a waiver in accordance with the provisions of clause 1.3, and either the beneficiary or that beneficiary's spouse thereafter changes his or her residence to another jurisdiction while they are still married to each other, the restrictions set forth in clauses 1.1 and 1.2 will once again govern distributions to that beneficiary

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unless the spouse of that beneficiary executes another waiver in accordance with the provisions of clause 1.3 which is satisfactory to the Independent Trustee in content and form under the laws of the jurisdiction in which the new residence is located.

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

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

1.5 It is my specific intention not to allow distributions for purposes beyond the immediate and direct personal needs for support and help of a beneficiary who is married as permitted in clause 1.2 which might be used to support or enhance his or her marital lifestyle, and which might lead to claims of reliance by the beneficiary's spouse in the event of divorce, and the assertion of claims for beneficial rights or interests with respect to income or principal of the trust estate, whether directly in the nature of a beneficial interest in the trust, or indirectly through the assertion of marital property rights or other interests in the beneficial interest of that beneficiary, unless the beneficiary's spouse has irrevocably and permanently waived the right to assert all claims and rights as provided in this clause 1. Unless I have made provisions for other persons by explicit terms in this [Will] [trust instrument], I intend for the assets which I have acquired during my lifetime to be used only for the benefit of my spouse and my descendants as provided in this [Will] [trust instrument]. I disavow any intention to make provisions for anyone else, including the spouses of my children and descendants, as it is their responsibility, not mine, to provide for their own spouses from assets and resources they acquire on their own efforts. I direct the Trustees to enforce these provisions rigorously, and to take a narrow and conservative view of the distributions which are permitted to be made to a married beneficiary in the absence of an irrevocable and permanent waiver that by that beneficiary's spouse.

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

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



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

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

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

An extreme form of such a clause is as follows:

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

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

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

- No patterns of distribution;
- Formalize the discretionary decision-making process regarding distribution decisions;
- Modifying problematic aspects of the trust agreement prior to the divorce (preferably well prior to the divorce);
- Delay distributions if a beneficiary's divorce is anticipated or following entry of a judgment in a divorce proceeding;
- Seek court intervention by the trustee to protect the trust (for example, petitioning for instructions, a declaratory judgment, or a protective order);

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- Avoid drastic changes in administration during divorce proceedings;
  - Consider migrating the trust to a state with stronger creditor protection; and
  - When a beneficiary is involved in a contested divorce proceeding, engage counsel and consider what the trust can reasonably do to protect itself and to consider the extent to which the trust could or should participate in the settlement discussions to minimize dissipation of the trust.

## 10. Privacy and Personal Security

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

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

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

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

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

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

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

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

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

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

- e. **Charitable Planning.**

(1) **Motivations.** Motivations for anonymous giving include a desire to minimize solicitations, to keep anonymous for philosophical reasons, to avoid the public spotlight, and to avoid personal security risks.

(2) **Methods of Anonymous Giving.** Methods for giving anonymously include –

- giving directly to a public charity (while the Form 990 for public charities must list substantial contributors, the IRS is required to redact the names and addresses of substantial contributors before it is publicly available),

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- giving through an agent under a written agency agreement or limited power of attorney (the charity's written acknowledgment of the gift may be used by the client to claim a charitable income tax deduction; if the gift must be reported on a Form 990 as a gift from a substantial contributor, the Instructions permit the donor to be identified as "anonymous" rather than disclosing the client's or agent's name and address),
  - giving through a revocable trust or LLC (with a name that is not easily recognizable and that has a separate taxpayer identification number),
  - giving to a designated fund at a community foundation (only the foundation's staff, but not the public, would be aware of the donor),
  - giving to a donor advised fund (gifts through a donor advised fund would allow anonymity to both the public and the ultimate charity), or
  - giving through a private foundation, by having the foundation make gifts to a designated fund or donor advised fund (grants from a private foundation directly to a public charity must be reported on the foundation's Form 990).
- f. **Political Contributions.** Political contributions made directly to a candidate or campaign committee are accessible on the Federal Election Commission's website. Gifts to a §501(c)(4) organization must be disclosed on Schedule B of Form 990, but the names and addresses of contributors can be redacted before the Form 990 is made public. Contributions to a §501(c)(4) do not qualify for a charitable income tax deduction (but may be deductible as a trade or business expense if they are ordinary and necessary in conducting the client's business).
- g. **Financial Privacy Planning.**
- (1) **Selection of Advisors.** Personal efforts in safeguarding financial information is the most effective means of securing financial privacy. Careful selection of banks, financial advisors and professionals will help ensure that the advisors maintain security measures to preserve client confidentiality.
  - (2) **Public Companies and Insiders.** Disclosure of detailed information is required for public companies and insiders under the federal securities laws. The required disclosures include the insider's compensation, including grants of stock options and stock appreciation rights, long-term incentive plan awards, pension plans, and employment contracts and related arrangements. Insiders of public companies include executive officers, directors, and 10% beneficial owners.
  - (3) **Lottery Winners.** Disclosure requirements for lottery winners are primarily set by state lottery commissions. A few states permit winners to protect identities. (For example, winners in Texas have the option to be private.) Most states, however, require that winners' names be made public (and sometimes that the winners participate in a press conference). Protecting the client's identity may be possible by claiming winnings through a trust or LLC or, in some states, by an attorney acting as trustee or agent for the client. For example, in 2010, a \$260.6 million Powerball jackpot was claimed by an attorney, acting as trustee, on behalf of an anonymous client.

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

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

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

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

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

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

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

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

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

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

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

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

k. **Dealing With Public Courts.**

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

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

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

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

(4) **Making Criminal Records Confidential.** Two options are available in most jurisdictions for limiting public access to criminal records: (1) expungement (the actual legal term is “expunction”), sometimes allowed only if the defendant was not

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convicted, or for certain misdemeanor convictions (requirements can include completing probation or maintaining a clean record for a certain period of time); and sealing the criminal record by obtaining an order of non-disclosure.

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

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

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

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

In a somewhat awkward case, the wife and girlfriend of a deceased man wrote competing obituaries that appeared side-by-side in a local newspaper. One obituary stated that the decedent "[was] survived by his loving wife." The other obituary, placed directly below the first, made no mention of the wife, but noted that the decedent was survived by "his long-time girlfriend." Hillary Hansen, *Deceased Man's Wife and Girlfriend Write Competing Obituaries*, HUFFINGTON POST, August 6, 2016, available at [http://www.huffingtonpost.com/entry/wife-girlfriend-write-obituaries-newspaper-us\\_57a5f548e4b021fd9878c5e3](http://www.huffingtonpost.com/entry/wife-girlfriend-write-obituaries-newspaper-us_57a5f548e4b021fd9878c5e3)

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

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

- m. **Cybersecurity.**

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

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

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

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

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

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

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

(5) **Zeus.** Mark Lanterman (Minnetonka, Minnesota) was called into a case in which a family office accused a bookkeeper of wiring almost \$1 million to Romania the prior day. The bookkeeper denied doing it. In searching her computer, Mark was able to confirm the bookkeeper’s story that she had used her RSA security token to check the bank account balance, took a break, and later looked at some pictures of wedding dresses. In the process of searching her computer, he discovered that the Zeus malware had been installed. He found that it had been installed earlier when she clicked a link in an email titled “Fraud Alert from FDIC.” It alerted small companies to



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be on the lookout for counterfeit cashier's checks that are difficult to identify. "If you want to see what they look like, click here." When she clicked the link, Zeus was downloaded. (When Mark hovered the cursor over that link, he saw that it went to another Web server, not the FDIC.)

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

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

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

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

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Planning considerations and alternatives include –

- maintain a low profile (be wary of posting personal information, travel schedules, etc. on social media; use aliases to obfuscate who is going to dinner or using football tickets, etc.);
  - home security systems ranging from inexpensive to complex and costly, and can include safe rooms (not like “panic rooms” in the movies, but it could be just a small bathroom or closet configured in the right way with bullet and bomb-proof walls, doors and windows, stocked with supplies to maintain the family for several days or more);
  - background investigations of potential and existing employees (“investigations” differ from “background checks,” which can be purchased on the Internet for \$19);
  - adopt appropriate policies and procedures, such as having required background investigations (insiders are the greatest personal threats to families, they have great access and tremendous authority); and
  - engage personal services, drivers, and bodyguards for higher security risk situations.
- o. **Assessment by Professional Security Services Firm.** A professional securities firm can provide an overall security assessment, with customized recommendations dealing with a comprehensive set of risks, including natural disasters, medical issues, insider threats, external threats, criminal activity, terrorism, activists, or state actors. The analysis would include (1) an assessment of the current situation, (2) the design of a program to address specific risks as desired by the client (which risks could include people, property, information, reputation, or privacy), (3) implementing countermeasures (possibilities include executive protection, counter surveillance, intelligence, cyber/IT, technology, or adopting appropriate policies and procedures; using appropriate manpower is a key, to make sure that they are not insider threats), and (4) reviewing operations to assure that the system works for the family, and works as new situations arise (a child traveling to Europe, some children in college, etc.)

## 11. Improving GRAT Performance

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

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

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

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

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

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

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

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

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- c. **Drafting Techniques for Reducing Exposure to Economic Risk.** Structure the GRAT so that only a nominal taxable gift results. If a significant gift is made upon creating a GRAT, and if the GRAT assets fail to produce sufficient growth, all of the trust assets could end up being returned to the grantor, thereby wasting use of the gift exemption amount.
- d. **Drafting Techniques for Reducing Mortality Risk.** If the Settlor dies before the stated termination date of the GRAT, a substantial portion or all of the GRAT assets will likely be included in the Settlor's estate.

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

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

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

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

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

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(5) **Avoiding Income Tax Issue if Settlor Predeceases Annuity Term.** If the Settlor dies before the end of the initial term, the trust will no longer be a grantor trust. If the trust thereafter satisfies the right to receive pecuniary annuity amounts with appreciated assets, taxable gain can result (if not all of the trust assets are included in the Settlor's estate or if appreciation occurs after the Settlor's death, or if carryover basis is enacted). To avoid this result, the Settlor could bequeath the right to receive the remaining annuity payments to a trust that gives the GRAT the power to withdraw all of the new trust's assets. That should result in the new trust being a grantor trust as to the GRAT (see Item 24 below), so transfers between them should not be taxable events.

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

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

(2) **Use Increasing Annuity Amounts.** The regulations permit the annuity amount to increase by up to 20% per year. Using increasing annuity amounts means that the annuity amounts in the earlier years will be much smaller, allowing the (hopefully) appreciating asset to remain inside the trust longer before it must be used in making in-kind annuity payments.

f. **Funding Techniques.**

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

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

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

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

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

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- (1) The client might contribute \$100,000 of marketable securities to a wholly-owned LLC, and might sell \$900,000 of securities to the LLC in return for a 3-year \$900,000 note.
  - (2) The net equity value of the LLC would equal the \$1 million value of securities in the LLC less the \$900,000 note, or \$100,000.
  - (3) The capital interest in the LLC (having a net value, without considering any discounts, equal to 10% of the value of the total LLC assets) would be contributed to a 3-year GRAT. Because of the 9-to-1 leverage of the LLC, if the \$1 million of securities grow at 10%, substantial value would remain in the GRAT at the end of 3 years.

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

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

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

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

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

(2) **GRAT With Positive Performing Assets.** Similarly, if a GRAT has substantial gains in early years, the Settlor might purchase those assets to avoid the risk of later

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reversals, and assuring that assets would remain in the GRAT at the end of the initial term.

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

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

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

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

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

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

- b. **Gift Tax.** The major gift tax issue is the value of the property that is sold. The IRS may also question the value of the note or argue that the note is valued at zero for

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gift tax purposes under §2702 (or perhaps under §2701) or because it is not a bona fide debt transaction.

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

- c. **Estate Tax.** Traditionally, the IRS has not argued that §2036 applies to sales to grantor trusts (and many sale transactions have been through audits without the IRS making that argument). However, the IRS argued that §2036 applies and the assets that were sold should be brought back into the seller’s estate in the *Woelbing* cases, which have now been settled as discussed below.
- **Step transaction issue regarding §2036.** The *Pierre* step transaction argument may come into play with the §2036 issue – if the IRS argues that the gift and sale should be treated as a single transaction – so that the transfer for full consideration exception of §2036 could not possibly apply (though the IRS does not appear to have made that argument directly in any case).
  - **Planning regarding §2036.** To help in defending against a §2036 argument for sales to grantor trusts, John Porter suggests (1) that the partnership distributions should not be made at the same time and in the same amounts as the note payments, and (2) separating the gift and sale so that the taxpayer can argue that the sale transaction is for full and adequate consideration and that the full consideration exception to §2036 applies.
  - **Repay note before death.** If the note is repaid by the trustee before the seller’s death, §2036 should not apply (and indeed §2035 should not apply even if the note is repaid within 3 years of death because the grantor/seller is not affirmatively relinquishing any deemed “retained interest;” it is the trustee that took the action to pay off the note).
  - **Further planning ideas to avoid §2036 argument.** Avoid the §2036 issue by having the grantor’s spouse or another grantor trust loan funds to the trust that will purchase the assets from the grantor for cash, so that note payments will not thereafter be made to the grantor/seller. *See Jonathan Blattmachr, Protecting an Estate Tax Plan from Turner, Trombetta, Davidson, Woelbing, Etc., ANNUAL NOTRE DAME ESTATE PLANNING INST. (2014).*
- d. **Woelbing Estates Cases.** The IRS attacked a sale to grantor trust transaction in two companion cases that were filed December 26, 2013 in the Tax Court. *Estate of Donald Woelbing v. Commissioner*, Docket No. 30261-13; *Estate of Marion Woelbing v. Commissioner*, Docket No. 30260-13. (These are pronounced “WELL-bing.”)
- In 2006, Mr. Woelbing sold that number of shares of non-voting stock in Carma Laboratories (a closely-held company located in Wisconsin) having a value of \$59 million to his grantor trust in return for a \$59 million note. The IRS questioned the



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value of the assets and the value of the note for gift tax purposes. It also argued that the stock was includable in the estate under §§2036 and 2038.

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

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

- e. **Planning Implications for Sales to Grantor Trusts.** For a more detailed discussion of the *Woelbing* cases and planning implications for sale to grantor trust transactions, see Item 11 of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).
- f. **Alternative to Sale to Grantor Trust Using Single Member LLC.** Stacy Eastland (Houston, Texas) suggests the possibility of using a single member LLC as an alternative to a sale to grantor trust. The client would contribute assets to a single member LLC in return for managing and non-managing interests and a note for about 90% of the value contributed. (Preferably, another grantor trust would also make a small contribution so the entity would still be disregarded for tax purposes but would have two members for state law purposes.) After some period of time, in a separate distinct and independent transaction, the client would give a 99% non-managing member interest to a grantor trust, valued at approximately 10% of the total assets in the LLC with appropriate lack of control and marketability discounts. The debt that leverages the transaction is inside the entity rather than being represented by a note from the grantor trust itself. This results in a tougher argument for the IRS to argue that the grantor has retained an interest in assets that were transferred to the grantor trust, because the grantor is not retaining the note in the course of making a transfer to the trust. (If the IRS succeeds in recharacterizing the note from the LLC as equity, it is just an equity interest in the LLC and not a retained interest in the grantor trust.) The economics are the same, however, as a sale to a grantor trust with a 9-1 debt to equity ratio. (Another advantage to this approach is that the pass-through treatment of the LLC could easily be avoided by merely admitting another person [not a grantor trust] to the LLC, meaning that it would no longer be a disregarded entity. In some circumstances, that might be easier than "turning off" grantor trust status in a sale to grantor trust transaction.)

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

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

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

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

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

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

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

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

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

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

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

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

**More Detailed Summary.** For a more detailed discussion of the facts and legal issues in *Estate of Davidson* and planning implications for SCINs, see Item 39.g of the Current Developments and Hot Topics Summary (December 2013) found [here](#) and Item 14 of the Current Developments and Hot Topics Summary (December 2014) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor). For a more

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detailed discussion of the facts that were alleged in the malpractice case (and that likely summarizes the weaknesses that the IRS emphasized in the settlement discussions), see Item 12 of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).

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

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

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

- a. **Types of Defined Value Formula Approaches.** John Porter reports that he has had a lot of success over the last few years in upholding transfers made under defined value formulas. Five basic types of these clauses exist:
- (1) Formula allocation clause, allocating portions of a transferred asset between taxable and non-taxable transfers based on the subsequent agreement of the parties (*McCord, Hendrix*);
  - (2) Formula allocation clause, allocating portions of a transferred asset between taxable and non-taxable transfers based on values as finally determined for federal gift tax purposes (*Christiansen, Petter*; both were full Tax Court cases approving these clauses and they were affirmed by the Eighth and Ninth Circuits, respectively);

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- (3) Clause defining the amount transferred based on values as finally determined for federal gift tax purposes (*Wandry*);
  - (4) Price adjustment clause (*King*; but *McLendon* and *Harwood* did not recognize price adjustment clauses; an advantage of price adjustment clauses is that a “re-transfer/re-titling” of assets is not required after the correct value is determined); and
  - (5) Reversions to donor of excess over a specified value (*Procter*)—this condition subsequent approach does NOT work. The clause in *Procter* provided that any amount transferred that was deemed to be subject to a gift tax was returned to the donor. It trifles with the judicial system, because any attempt to challenge the gift or raise gift tax defeats the gift. The *Procter* doctrine does not invalidate all formula transfers. Since the 1944 *Procter* case, many other types of formula clauses have been blessed by the IRS and the courts (marital deduction clauses, GST formula allocations, split interest charitable trust clauses, GRATs, formula disclaimers, etc.).

*General Observations.*

- In the charity cases, the charities received 6-figure values; the charity preferably should have “skin in the game” to review the transaction closely.
  - The IRS, even in cases involving charities, likely view these transactions as “shams” in the sense that the charity will find no buyers of the closely held interest other than the family.
  - The IRS looks at these cases closely, but largely at whether the clause was implemented properly. No pre-arrangements should exist.
  - With a *Petter* type of formula (based on values as finally determined for gift tax purposes) it is essential that a gift tax return be filed.
- b. **2015-2016 Treasury Priority Guidance Plan Project.** The 2015-2016 Priority Guidance Plan (sometimes referred to as the IRS’s “Business Plan”) added the following item: “Guidance on the gift tax effect of defined value formula clauses under §2612 and 2511.” See Item 5 above. Apparently, the IRS is adding a regulations project to address defined value formula clauses.
  - c. **Structuring Allocation Clauses.** Formula allocation clauses are supported by more judicial authority if the portion passing as a non-taxable transfer passes to charity. The “excess” value could pass to a public charity-donor advised fund (to avoid complex self-dealing and excess business holdings issues for private foundations). Other possible “pour-over” non-taxable recipients could include a surviving spouse, QTIP trusts or GRATs. If a QTIP trust or GRAT is used for the non-taxable portion of the transfer, the best approach is to use different trustees and somewhat different beneficial interests compared to the trust that receives the taxable portion of the transfer.
  - d. **Compliance Best Practices.** If a clause is used that is based on values as finally determined for federal gift tax purposes, a federal gift tax return must be filed reporting the formula transfer, or else a final determination of the gift tax value will never arise. The transaction should be reported on the gift tax return consistent with

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the formula transfer, providing that all that was transferred is the amount determined by the formula, but the units are initially allocated based on values as reflected in an attached appraisal.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(1) **Section 2036(a)(1).** The IRS typically argues that assets should be included under §2036(a)(1) as a transfer to the FLP/LLC with an implied agreement of retained enjoyment. The government wins about 2/3 of those cases. (In some of those cases, the FLP/LLC assets have been included in the estate under §2036 even though the decedent had transferred the partnership interests during life (*Harper, Korby*.)

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

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

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

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

- b. **Other Issues – §2703 and Indirect Gift.** Other issues that the IRS sometimes raise in audits regarding FLP/LLCs are (1) whether specific restrictions in partnership agreements should be ignored for tax purposes under §2703 (*Holman* and *Fisher II*) and (2) whether contributions to an FLP/LLC immediately followed by gifts or interests in the entity should be treated as indirect gifts of the underlying assets of the entity (*Holman*, *Gross*, *Linton*, and *Heckerman*).
- c. **Chart of FLP/LLC Discounts.** John Porter has prepared a helpful chart summarizing the discounts that have been recognized in cases involving FLP or LLC interests. See the Appendix of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).



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

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

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

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

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

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

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

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

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

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

(2) **No Bona Fide Sale for Full Consideration.** The court concluded that three nontax reasons asserted for creating the partnership were not legitimate and significant. (1) Protection from “extortion by trial attorneys” – the decedent had never been sued; because she lived in a nursing home her risk of vulnerability to trial attorney extortion was minimal; and she retained significant assets that could be reached by someone trying to extort something from her. (2) Protecting against undue influence of caregivers – while caregivers had taken advantage of or stolen from other family members, the decedent’s situation was different because her sons managed her affairs and visited her often; this concern was not discussed with the decedent when the partnership was formed, and there was no evidence she was concerned about undue influence from a caregiver. (3) Preservation of assets for the decedent’s heirs – other structures for preserving assets were “quickly dismissed” because they were difficult to manage, but that was unconvincing because the decedent’s previously deceased husband’s assets were being managed in trusts without difficulty; also the decedent was not involved in selecting the structure used to preserve her assets.

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

- The decedent “stood on both sides of the transaction” and it was not an arm’s-length transaction because there was no meaningful negotiation or bargaining associated with the transaction. [Planners argue that this “standing on both sides” argument should have no relevance because a transfer is “bona fide” as

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long as it is real and not a sham regardless of third party negotiation, but since this argument was first included in a case years ago, it gets repeated in almost every FLP §2036 case. Its relevance was severely questioned in *Purdue* (as discussed above).]

- Various formalities were not followed including the absence of books and records other than brokerage statements, formal meetings were not held and minutes were not kept, the requirement under the agreement to make distributions was not followed, and compensation was not paid to the general partner as required under the agreement.
- The marketable securities were not actively managed and were only traded on limited occasions. [The absence of any activity in the partnership gave the appearance that assets were transferred to the partnership merely to get a valuation discount.]

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

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

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

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

The decedent died in 2007.

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

**Section 2036.** The court determined that all of the FLP assets were included in the decedent’s estate under §2036(a)(1). The bona fide sale for full consideration exception to §2036 did not apply. The transfers to the FLP were not bona fide because the purported nontax reasons for the trust were not recognized as the actual legitimate purposes for which the FLP was created. (These included keeping the Abbott stock and investment portfolio intact, providing management transition, and

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providing continuity of management.) Furthermore, the “full consideration” requirement was not satisfied because of the failure to maintain proper capital accounts. The decedent had an implied agreement of retained enjoyment, based primarily on the actual distributions made to the decedent and for the decedent’s estate and because the decedent had not retained sufficient assets to satisfy his anticipated financial obligations. The *Beyer* case involved a massive failure of following formalities, and one suspects this failure to respect the partnership may have had a significant impact on the credibility of the position that the partnership was created for legitimate and significant nontax purposes.

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

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

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

## 16. Portability

- a. **Brief Background.** Section 303(a) of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the “2010 Tax Act”) allows portability of any unused “basic” exclusion amount (changed to “applicable” exclusion amount in ATRA) for a surviving spouse of a decedent who dies after 2010 if the decedent’s executor makes an appropriate election on a timely filed estate tax return that computes the unused exclusion amount. The unused exclusion amount is referred to in the statute as the “deceased spousal unused exclusion amount” (referred to as the “DSUE amount.”) The surviving spouse can use the DSUE amount either for gifts by the spouse or for estate tax purposes at the surviving spouse’s subsequent death. An individual can only use the DSUE amount from his or her “last deceased spouse.”

The IRS issued final regulations, effective June 12, 2015, which made relatively few revisions from the temporary regulations. Highlights of some of the more important provisions of the regulations include:

- The portability election is made by the executor’s filing a timely and complete Form 706 (if the estate tax return is not timely filed and if the estate is small enough that no return would otherwise be required, Rev. Proc. 2014-18 allowed a relief procedure for certain estates through December 31, 2014, and 9100 relief is

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available otherwise as long as the estate was not required to file an estate tax return, Reg. §20.2010-2(a)(1); one of the requirements for 9100 relief is that the taxpayer sought professional advice, but the rulings often do not mention that fact so the IRS is apparently being lenient with respect to that requirement in this context);

- In most cases no need to list values of assets passing to a surviving spouse or charity on the “timely and complete” Form 706 exists if the estate was not otherwise required to file an estate tax return (but the return must include an estimate of the total value of the gross estate within specified ranges, including assets passing to a spouse or charity);
- The surviving spouse’s DSUE amount is not subject to being reduced if Congress later reduces the basic exclusion amount;
- The regulations adopt the “Example 3” approach of the Joint Committee Technical Explanation, negating any “privity” requirement in calculating the DSUE amount (an approach adopted legislatively by ATRA);
- If the decedent made gifts requiring the payment of gift tax, the excess taxable gift over the gift exemption amount (on which gift tax was paid) is not considered in calculating the DSUE amount;
- The surviving spouse can use the DSUE amount any time after the decedent’s death, assuming the portability election is eventually made by the executor;
- Any gifts made by the surviving spouse are first covered by the DSUE amount, leaving the spouse’s own exclusion amount to cover later transfers;
- DSUE amounts from multiple spouses may be used to the extent that gifts are made to utilize the DSUE amount from a particular spouse before the next spouse dies; and
- If the estate leaves assets to a QDOT, the surviving spouse cannot use the DSUE amount until the QDOT is fully distributed (or terminates at the surviving spouse’s death).

For a detailed discussion of the temporary and proposed regulations see Item 6(h-q) of the December 2012 summary, “Estate Planning Current Developments and Hot Topics” found [here](#) and available at [www.bessemer.com/advisor](http://www.bessemer.com/advisor).

For a more detailed discussion of portability planning (including the advantages and disadvantages of various approaches) see Item 8 of the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).

- b. **Using QTIP Trust Planning With Portability, Rev. Proc. 2016-49, Modifying and Superseding Rev. Proc. 2001-38.** The IRS on September 27, 2016 released Rev. Proc. 2016-49 to modify and supersede Rev. Proc. 2001-38 and clarify that portability can be used in connection with QTIP trusts. Rev. Proc. 2001-38 gave estates the option of electing to treat an unneeded QTIP election (if the QTIP election was not needed at all to reduce the estate tax to zero) as null and void. Some planners were

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concerned that the IRS might nullify QTIP elections when they were not needed to reduce the estate tax to zero, thus leaving less unused exclusion (DSUE amount) if the portability election were made, and keeping the trust assets from being included in the surviving spouse's estate to achieve a basis adjustment at the surviving spouse's subsequent death. See e.g., Rodney L Goodwin, *IRS Rules No Date-of-Death Basis on Death of Surviving Spouse—PLR Finds QTIP Election Null and Void*, TRUSTS & ESTATES (June 20, 2016) (discussing PLRs 201615004 & 201603004).

The preamble to the portability final regulations (T.D. 9725) stated that the IRS intended to provide guidance to “clarify whether a QTIP election made under section 2056(b)(7) may be disregarded and treated as null and void when an executor has elected portability of the DSUE amount under section 2010(c)(5)(A).” The 2014-2015, 2015-2016, and 2016-2017 Priority Guidance Plans have included this project. Planners have speculated why the guidance has taken such a long time to complete. Perhaps the IRS was concerned with avoiding potential abuses such as: (i) nullifying a QTIP election after DSUE amount had been used to shelter gifts by the surviving spouse; (ii) nullifying a QTIP election if the surviving spouse remarried, thus losing the first spouse's unused DSUE amount; or (iii) nullifying the QTIP election if the QTIP assets decline in value by the time of the surviving spouse's death to avoid a step-DOWN in basis under §1014.

**Purpose.** Rev. Proc. 2016-49 explains that the purpose of Rev. Proc. 2001-38 was to provide relief to estates that inadvertently made the QTIP election at the first spouse's death when the election was not needed to reduce the estate tax. The surviving spouse's estate could nullify the QTIP election so that the assets in the QTIP trust would not be included in the surviving spouse's gross estate. The new revenue procedure explains that with the amendment to the Code allowing portability elections, a deceased spouse's estate may wish to elect QTIP treatment for property even when not necessary to reduce the estate tax liability, in order to leave a greater DSUE amount that could be utilized by the surviving spouse.

**Operation of Rev. Proc. 2016-49.** The new procedure requires an affirmative election by the taxpayer seeking to nullify the QTIP election and generally treats a QTIP election as void only if (i) the federal estate tax was zero regardless of the QTIP election, (ii) no portability election was made, and (iii) the taxpayer follows specified procedural requirements to treat the QTIP election as void.

The procedural requirements include: (i) filing a supplemental Form 706 (if the period of limitations has not expired), a Form 709 by the surviving spouse, or a Form 706 by the surviving spouse that has a notation at the top of the Form stating “Filed pursuant to Revenue Procedure 2016-49”; (ii) identifying the QTIP election that should be treated as void and explaining why the QTIP election was not needed to reduce the estate tax (because the taxable estate was less than the decedent's applicable exclusion amount) and that the portability election was not made (for example, because of an affirmative statement attached to the prior return declining to make the portability election or because the return was not timely filed); and attaching sufficient evidence to establish those facts (which could, for example, include a copy of the predeceased spouse's estate tax return or an account transcript reflecting that the estate tax return was filed late).

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The revised procedure, allowing nullification of the QTIP election only if the portability election was not made on the predeceased spouse's return, avoids (or at least minimizes) potential abuse situations. (This is the approach recommended by the American Bar Association Real Property, Trust & Estate Law Section in comments filed with the IRS on June 11, 2013.)

This issue is important for portability planning. Being able to use QTIP trust planning creates flexibility by being able to decide after the first spouse dies whether to make a full QTIP election (and rely on portability to save estate taxes at the second spouse's death) or whether not to make the QTIP election and allow the assets in the QTIP trust to pass into a credit shelter trust.

The new procedure allows taxpayers to take steps, in appropriate situations, to nullify QTIP elections without having to incur the significant expense of obtaining a private letter ruling, which was required under Rev. Proc. 2001-38.

- c. **Portability Decision is Complex.** Married clients may be more inclined to proceed with fairly simple "all to spouse" will planning, relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning. From the planner's perspective, this is a more complex decision involving a wide variety of factors that might apply at the first spouse's death (including the surviving spouse's age and life expectancy, whether assets will likely appreciate substantially, whether assets may be sold during the spouse's lifetime, whether assets will be held long-term even after the surviving spouse's death, whether the assets are those kinds that have larger than normal capital gains rates, the states where the beneficiaries live and their estate and income tax rates, whether net consumption of the estate will likely occur, whether it is important to use trusts that allow both the surviving spouse and children to be potential beneficiaries, etc.).

Clients living in states with state estate taxes may use a combination of a credit shelter trust (up to the state exemption amount) and portability.

A major tax disadvantage of routinely using bypass trust planning is failing to get a second basis adjustment at the surviving spouse's subsequent death with respect to assets in the bypass trust. If a client has no transfer tax concerns, a bypass trust can result in tax disadvantages. Other nontax reasons exist, however, as to why using bypass trust may be important, including blended family concerns, the desire to use trusts of which the surviving spouse and descendants are all discretionary beneficiaries, and the remarriage potential (which might result in losing the first decedent's exemption amount if the new spouse predeceases).

Making these decisions can be postponed until the first spouse's death when drafting documents for a couple by using a single QTIP approach or by building in ways to use disclaimers at the first spouse's death. See Item 3.h.(3) above.

For a more detailed discussion of the advantages and disadvantages of the credit shelter trust approach and the portability approach, as well as a detailed discussion of complexities and inequities that can arise in a blended family situation if a credit shelter trust is not used at the first spouse's death, see Item 13.d of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and Item 5.d-f of the Current Developments and Hot Topics Summary (December 2014) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).

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- d. ***Estate of Vose, Court Forces Executor to Make Portability Election Despite Marital Agreement Waiving All of Surviving Spouse's Rights to Decedent's Estate.*** The Oklahoma Supreme Court affirmed the lower court's decision forcing the executor to file an estate tax return making the portability election, even though the surviving husband had signed a prenuptial agreement waiving "all claims and rights, actual, inchoate, vested, or contingent" in the estate. *In re Matter of the Estate of Anne S. Vose v. Lee*, \_\_ P.3d \_\_, 2017 WL 167587 (Okla. Jan. 17, 2017). This is a case of national first impression, addressing (i) whether a prenuptial agreement waiving "all claims and rights" to an estate waived any interest that the surviving spouse had in the DSEU amount if the portability election were made, and (ii) an executor's fiduciary duty to make the portability election where the spouse was not a beneficiary of the estate.

Regarding the prenuptial agreement issue, the court observed that a valid waiver requires "full knowledge of the rights intended to be waived," that §2010 (enacted after the agreement was signed) granted the husband "a potential interest in a part of Decedent's estate," and distinguished the waiver of all "claims and rights" in the estate by concluding that "[t]he portable DSUE is not simple property acquired by one party over the course of the marriage according to existing laws in effect when the agreement was made." This is a case of first impression regarding the reach of a pre-existing prenuptial agreement attempting to waive "all rights" in an estate, whether known or unknown, but that pre-dated the portability election and obviously did not mention portability. The case emphasizes the importance of specifically addressing the parties' intentions regarding portability in structuring prenuptial agreements. See generally George D. Karigjanian and Lester B. Law, *Portability and Prenuptials: A Plethora of Preventative, Progressive, and Precautionary Provisions*, BNA Estate, Gift and Trusts J., (March-April 2013).

The court emphasized that the personal representative had a fiduciary relationship to "all parties that have an interest in the estate," and that the surviving husband is the only person that has "an interest in and the ability to use the DSUE" amount. The personal representative argued that the estate should be able to demand consideration from the surviving husband, but the court focused on the fact that the DSUE would be lost if the election were not made and that the surviving husband agreed to pay any costs associated with filing the return to make the election.

The significance of this case of first impression is summarized:

The Court determined that Personal Representative has a "fiduciary obligation to ... safeguard [Surviving Spouse's] interest in the DSUE [amount]." This is novel! Even though the Court never stated that the DSUE amount is an estate asset, by imposing on Personal Representative the duty to safeguard the DSUE amount for Surviving Spouse, the Court treated it as such.

#### **Monday Morning Quarterback Analysis of the Decision**

After reviewing the Court's decision and "reading between the lines," we believe that the holding is based on the two important facts. First, there would be great loss to Surviving Spouse if the election were not made, and there would be absolutely no harm to the estate in making the election. Second, the Court applied the "we won't tolerate unreasonable personal representatives" rule.

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This is a true case of national first impression. Since the early days of portability, we anticipated that a case similar to this would eventually surface, we did not necessarily anticipate this the result and/or the court's reasoning. We believe that the case left many unanswered questions, but yet gave some idea of how other state courts may view the issue. The best lesson learned from this case is that one should now, more than ever, be diligent about addressing the issue of making the portability election in the planning phase for the clients.

Lester Law & Howard Zaritsky, *In re Matter of the Estate of Anne S. Vose v. Lee: Court Forces the Portability Election – Is Pandora's Box Open?*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2513 (February 8, 2017).

- e. **Planning Considerations.** For a detailed discussion of planning considerations, including major factors in bypass planning versus portability, methods of structuring plans for a couple to maximize planning flexibilities at the first spouse's death, ways of using the first decedent-spouse's estate exemption during the surviving spouse's life, whether to mandate portability, whether to address who pays filing expenses to make the portability election, state estate tax planning considerations, and the financial impact of portability planning decisions, see Item 5 of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).
- f. **Forms.** The 2017 Heckerling materials regarding portability by Lester Law and Howard Zaritsky have outstanding forms for a wide variety of issues regarding portability planning including: basis adjustment planning flexibilities [power to grant a general power of appointment, formula general powers of appointment, and exercising a power of appointment to trigger the Delaware tax trap], marital agreement provisions regarding portability, and will provisions regarding directions for portability elections and payment of expenses.

## 17. State Income Taxation of Trusts

- a. **Background.** All of the 43 states plus the District of Columbia that impose an income tax on trusts tax the undistributed income of a non-grantor trust as a "resident trust" based on one or more of the following five criteria: (1) if the trust was created by a resident testator (for a testamentary trust), (2) if the trust was created by a resident trustor (for an inter vivos trust), (3) if the trust is administered in the state, (4) if the trust has a resident fiduciary, and (5) if the trust has a resident beneficiary. Observe that the governing law of the trust is not one of those criteria (except in Louisiana; also in Idaho and North Dakota that is a factor considered along with other factors). A trust included in one of the first two categories is referred to as a "founder state trust" (i.e., the trust is a resident trust if the founder of the trust was a resident of the state).  
See Item 20.d of the 2012 Heckerling Musings found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor) for a summary of the court cases that have addressed the constitutionality of state tax systems that tax trusts based on the testator of a testamentary trust or settlor of an inter vivos trust residing in the state. Based on those cases, most commentators believe that taxing a nonresident trust solely because the testator or settlor was a resident is probably unconstitutional. However, if that state's court system is utilized, for example, because of a probate proceeding in that state, chances are better that the state does have the authority to tax the trust.

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- b. **Significance.** This issue is arising more frequently as (1) states are strapped for revenue and are getting more aggressive, and (2) beneficiaries and individual trustees are more mobile, which may have the effect of changing the tax situs. Beware of naming family members as trustee without considering whether the appointment could cause the trust to be subject to income tax in the state of the trustee's residence. These issues are exacerbated by the trend of splitting up trustee functions among co-trustees, increasing the possible likelihood of having at least one co-trustee in a state that uses the trustee's residence as a basis for taxing trusts.
- c. **Recent Trend of Cases Rejecting Constitutionality of State Trust Taxation Approaches.** Recent cases have held or suggested that Illinois, New Jersey, North Carolina, and Pennsylvania could not tax trusts merely because the settlor was a resident of those states when the trust was created. *E.g., Linn v. Dep't of Revenue*, 2013 IL App (4th) 121055 (2013); *McNeil v. Commonwealth of Pennsylvania*, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011 (2013). For further discussion about the details of each of these cases (and other 2013 cases in North Carolina and New Jersey), see Item 22.a of the Current Developments and Hot Topics Summary (December 2014) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).

Two of the earlier North Carolina and New Jersey lower court cases have been addressed further in 2015. In *Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 12 CVS 8740 (N.C. 2015), the lower court held on summary judgment that "the beneficiary's residence in North Carolina, standing alone, is not a sufficient contact by [a trust] with this State to support the imposition of the tax at issue," citing the Due Process Clause and the Commerce Clause of the U.S. Constitution. The North Carolina Court of Appeals affirmed, finding the state tax unconstitutional on the grounds that the minimum contacts criteria of the Due Process Clause were not satisfied, (N.C. Ct. App. July 5, 2016).

*Residuary Trust A u/w/o Kassner v. Director, Division of Taxation*, 2015 N.J. Tax LEXIS 11, 2015 WL 2458024 (N.J. Sup. Ct. App. 2015), *aff'g* 27 N.J. Tax 68 (N.J. Tax Ct. 2013) is the appellate case affirming the 2013 lower court opinion. The trust's only connection to New Jersey was that it was a shareholder of an S corporation that owned New Jersey assets. The trust paid tax on its portion of the flow through income from the S corporation's New Jersey assets but not on its other income. The court concluded that the announcement in the Division of Taxation's official publication that the trust income would not be taxed under certain circumstances and then changing that position retroactively was fundamentally unfair. The court did not address constitutional issues.

- d. **Supreme Court-Credits for State and County Taxes From Other States.** In *Comptroller of the Treasury of Maryland v. Wynne*, 135 S. Ct. 1787 (2015), Maryland residents had taxable income from an S corporation that was sourced in several other states. They paid taxes to those states and sought a credit for the taxes paid against their Maryland state and county income taxes. They received a credit against their state income tax, but not the county level tax. The Supreme Court affirmed the Maryland Court of Appeals finding that the failure to provide the credit at the county level unconstitutionally discriminated against interstate commerce. The failure to provide the credit violates the dormant Commerce Clause by burdening out-of-state business with double taxation.

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- e. **Corporate Trustee Treated as “Inhabitant” of State.** Massachusetts taxes inter vivos trusts created by residents of the state if a trustee or beneficiary is a resident of the state. In *Bank of America, N.A. v. Massachusetts Commissioner of Revenue*, C314596-8; 314606-36 (Mass. Appellate Tax Board. June 10, 2015), 2016 Mass. LEXIS (July 11, 2016), the Massachusetts Supreme Judicial Court concluded that a national bank with offices in Massachusetts was determined be an “inhabitant” of Massachusetts and was therefore a resident trustee.
  - f. **Annual Review of Trust Status.** Trustees should inquire annually whether co-trustees or beneficiaries have moved to a new state. If so, the trustee should determine whether the new state taxes trusts based on the residency of a trustee or beneficiary, whether that system is constitutional, and if not, make decisions how to proceed.

## 18. Tax Effects of Settlements and Modifications

The tax effects of court modifications, other trust modifications, decanting, and settlements are summarized in Items 42-51 of the ACTEC 2015 Annual Meeting Musings summary found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor). This Item includes several brief miscellaneous comments.

- a. **Significance.** Settlements and trust modifications can have tax effects. Litigators nearing the end of long mediations or settlement discussions often will just make an off-hand comment that “we agree there are no tax issues.” One or more of the parties later will be most unhappy when advised of the tax effects (and, indeed, may make attempts to set aside the settlement agreement).
- b. **Court Judgments—*Bosch*.** *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967) addresses the respect that federal courts must give to state court proceedings in tax cases. A trustee brought a construction suit requesting whether the wife’s release of the general power of appointment was effective under state law. The trial court ruled that the release was a nullity. The Tax Court and Second Circuit Court of Appeals allowed a marital deduction for assets passing from the trust at the husband’s death because the surviving wife had a general power of appointment. The Supreme Court observed that legislative history regarding the marital deduction directed that “proper regard” be given to state court construction of wills. Because the Senate stated “proper regard” rather than “final effect,” the opinion concluded that state court decisions should not be binding on the issue, and that federal courts in tax cases will be bound only by the state’s highest court in the matter before it.
- c. **Settlements—*Ahmanson*.** The *Bosch* approach is applied to settlements in *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981). A four-part test is used to determine if the results of a settlement will govern the tax consequences. (1) *Dispute* – the case arose from a bona fide dispute. (2) *Bona Fide Claim* – the amount received by the parties should be something that is premised on a bona fide claim under state law. (3) *Quantitative Test* – the recipient does not receive more property than could be covered if the person received a full recovery following a trial. (4) *Qualitative Test* – amounts received must be of a character and nature of what the person was entitled to under state property rights. (For example, if a residual beneficiary settles for a fixed sum of money, it cannot take a position that it received a specific bequest that does not carry out DNI.)

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If the IRS concludes that a bona fide controversy does not exist, it can either treat the exchange of property as a gift or as a sale for full consideration, depending on the situation.

Effectively, the IRS seems to be taking the position that a “settlement tax” exists. The IRS is more inclined to give consideration to a court judgment, but totally ignore settlements because they are viewed as collusive transfers. The courts and national office of the IRS typically realize that the four-part analysis applies, but individual examiners are extremely suspicious of collusion in settlements.

- d. **Revenue Ruling 73-142—Pre-Transaction Actions Can Avoid *Bosch* Analysis.** In Rev. Rul. 73-142, a Settlor reserved the power to remove and replace the trustee with no express limitation on appointing himself, and the trustee held tax sensitive powers that would cause estate inclusion under §§2036 or 2038 if held by the grantor *at his death*. The Settlor obtained a local court construction that the Settlor only had the power to remove the trustee once and did not have the power to appoint himself as trustee. After obtaining this ruling, the Settlor removed the trustee and appointed another, so the Settlor no longer had the removal power. In Revenue Ruling 73-142, the state court determination, which was binding on everyone in the world after the appropriate appeals periods ran, occurred *before the taxing event*, which would have been the Settlor's death. The IRS agreed that it was bound by the court's ruling as well:

In this case the lower court had jurisdiction over the parties and over the subject matter of the proceeding. Thus, the time for appeal having elapsed, its judgment is final and conclusive as to those parties, *regardless of how erroneous the court's application of the state law may have been*. Consequently, after the time for appeal had expired, the grantor-decedent did not have the power to appoint himself as successor trustee. The aforesaid rights and powers which would otherwise have brought the value of the trust corpus within the provisions of sections 2036 and 2038 of the Code were thus effectively cut off before his death.

Unlike the situation in *Bosch*, the decree in this case was handed down *before the time of the event giving rise to the tax* (that is, the date of the grantor's death). Thus, while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such *date since the decree, in and of itself, effectively extinguished the power*. In other words, while there may have been a question whether the grantor had such power prior to the decree, there is no question that he did not have the power thereafter. Rev. Rul. 73-142, 1973-1 C.B. 405 (emphasis added).

Get the construction proceeding final order before the taxing event, and the IRS will be bound under Revenue Ruling 73-142. But the prior court order must be obtained *prior to* the event that would otherwise have been a taxable event.

- e. **Construction vs. Reformation/Modification Proceedings.** A construction proceeding interprets a document as signed. It often involves an ambiguous document. The IRS is essentially bound regarding the availability of a marital or charitable deduction, because the interpretation relates back to the date of execution of the instrument (assuming the four-part analysis of settlement agreements can be satisfied).

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A reformation modifies a document, and the IRS position is that the reformation applies prospectively only. Accordingly, a post-death reformation may not result in an action causing assets to have passed to a surviving spouse or charity as of the date of death to qualify for an estate tax marital or charitable deduction.

Planners may be creative in finding an ambiguity that can be used in a construction proceeding, rather than using a reformation/modification proceeding, in light of the more favorable tax treatment resulting from construction actions. In *Hubble Trust v. Commissioner*, T.C. Summ. Op. 2016-67, a trust instrument gave the trustee the authority to use and distribute “[a]ll unused income and remainder of the principal ... as will make such uses and distributions exempt from Ohio inheritance and Federal estate taxes and for no other purpose.” The local court entered an order that the trust was ambiguous and that it authorized the trustees to make charitable distributions. The Tax Court agreed with the IRS that no latent ambiguity existed that could be construed by the probate court (even though the drafting attorney believed that the trustees were supposed to be authorized to make charitable distributions), and that distributions did not qualify for an income tax charitable deduction.

- f. **Recent Rulings Regarding Tax Effects of Court Modifications.** A recent Chief Council Advice refused to give effect to a court modification for purposes of whether or not charitable distributions were made “pursuant to the terms of the governing instrument.” CCA 201651013. The trust was modified to give the beneficiary a limited power of appointment in favor of charity. The IRS concluded that if the beneficiary exercised a power of appointment to make distributions to charity, a charitable deduction would not be available under §642(c) because the distribution would not be made pursuant to the terms of the governing instrument. This conclusion seems incorrect; if the governing instrument is effectively modified under state law before the transfer to charity, it would seem to be made pursuant to the terms of the governing instrument in the absence of guidance under §642(c) that it looks only to the governing instrument as drafted, without valid modifications.

A recent private letter ruling concluded that a court ordered division of a “pot” trust into separate trusts for the beneficiaries would not have adverse GST, income, estate or gift tax consequences. PLRs 201702005 & 201702006 are good examples of rulings that have analyzed these issues with respect to court modifications. (Other PLRs holding that the division of a trust into separate trusts for the beneficiaries did not have gift tax consequences are PLRs 200419001, 2013409002, 201245007, 201243006, 201238004, 201218003, and 201205001. Similar rulings regarding the gift tax treatment of mergers of trusts are PLRs 201025026, 201024044, 201024017-201024024.)

A GRAT that left out some technical requirements was modified in a judicial action to satisfy the requirements in PLR 201652002. The IRS concluded that the modification corrected a scrivener’s error, observing that the trust instrument provided that the grantor’s retained interest was intended to constitute a qualified interest within the meaning of §2702(b)(1).

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- g. **Gift Effects.** Because settlements by their nature involve compromise, an ever-present concern is whether any of the parties to the agreement have made a taxable gift. Transfers in compromise and settlement of a trust or estate dispute typically will be treated as transfers for full and adequate consideration that do not result in gifts. The IRS has issued a number of favorable private letter rulings finding no gift tax exposure in a variety of settlement or court modification/construction contexts. *E.g.*, PLRs 201342001, 201223012, 201220030, 201216010, 201210002, 201147010, 201104001, 200845028, 200825007, 200638020, 200631008, 200615006, and 200209008.
- h. **Redstone Cases.** A settlement of litigation resolved a dispute regarding the ownership of 100 shares of closely-held stock registered in the name of Edward Redstone. The settlement resulted in the company agreeing to pay \$5 million for 66  $\frac{2}{3}$  shares to Edward, with the remaining 33  $\frac{1}{3}$  shares being held in a trust for his children. The dispute centered around disagreements between Edward and his father, who was the president of the company, and who insisted that a portion of the shares were held in an “oral trust” for the benefit of the shareholder’s children. The court concluded that the settlement constituted a bona fide, arm’s length transaction that was free from donative intent and that was “made in the ordinary course of business.” The transfer was made “for a full and adequate consideration in money or money’s worth,” which was the recognition that Edward was the outright owner of 66  $\frac{2}{3}$  of the shares in the agreement and that the company would pay \$5 million in exchange for the shares. (The fact that Edward’s children were not parties to the settlement agreement - and therefore provided no consideration for the transfer of the shares - did not matter for purposes of determining whether Edward received full consideration in the settlement.) *Estate of Edward Redstone v. Commissioner*, 145 T.C. 259 (2015) (Judge Lauber).

Edward’s brother, Sumner Redstone, similarly had 100 shares of the company registered in his name. Three weeks after the settlement between Edward and the company was signed (and two days after the parties filed a stipulation with the court and the court issued a final decree incorporating the terms of the settlement agreement), Sumner engaged in similar transactions—agreeing to be paid \$5 million for 66  $\frac{2}{3}$  shares and transferring his remaining 33  $\frac{1}{3}$  shares to irrevocable trusts for his children. Sumner said that he did this as a “gesture of goodwill to his father, who desired to ensure the financial security of his four grandchildren on equal terms,” but Sumner was not required to take these actions under the settlement agreement between Edward and the company. The Tax Court (the same judge that wrote the opinion for the *Edward Redstone* case) concluded that Sumner’s transfer of shares to the trusts for his children constituted taxable gifts, reasoning that pleasing parents is presumptively a family motivation. The court concluded: “There was no claim against Sumner; there were no arm’s length negotiations; and he received no consideration from anyone in exchange for his transfer.” *Sumner Redstone v. Commissioner*, T.C. Memo. 2015-237 (2015) (Judge Lauber).

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In the *Edward Redstone* case, the court provided a planning roadmap in summarizing factors that the courts have considered to determine the tax consequences in a litigation settlement context:

whether a genuine controversy existed between the parties; whether the parties were represented by and acted upon the advice of counsel; whether the parties engaged in adversarial negotiations; whether the value of the property involved was substantial; whether the settlement was motivated by the parties' desire to avoid the uncertainty and expense of litigation; and whether the settlement was finalized under judicial supervision and incorporated in a judicial decree. 145 T.C. at 271.

- i. **Correcting Failure to Fund Trusts.** The manner in which a claim is couched can impact the tax effects of the modification. For example, if a surviving spouse fails to take steps to fund a bypass trust prior to his or her death, alternative arguments are a (i) debt approach (a claim for damages against the decedent), (ii) a constructive trust approach, (iii) a "vested" approach (*see Estate of Richard v. Commissioner*, T.C. Memo 2012-173 (2012)), or (iv) a "by their fruits" approach (*Estate of Olson v. Commissioner*, T.C. Memo 2014-58 (2014)). Under the debt approach, all of the assets would be in the surviving spouse's gross estate and a basis adjustment would be permitted at her subsequent death.

## 19. Engaging New Clients

- a. **Screening Prospective Clients.** "A lawyer should be measured not by the clients he has but by the clients he has turned away." Not taking a bad case can be much more important than accepting a good case because of the inordinate frustration, lost time, and liability risk in dealing with unhappy clients.

Examples of free self-help search tools for screening clients include search engines (Google), local/county public records databases, state corporate registration databases, Corporation Wiki, credit reports, FINRA, SEC registrations, state licensing and regulatory agencies, and Interpol. Consolidated search tools include Accurint by LEXIS-NEXIS, Westlaw, TLO, KnowX, and State Criminal Records Services. (One speaker's firm typically uses Accurint, which produces a pretty comprehensive report for about \$20 per prospect.)

The level of due diligence may vary depending upon the type of representation and perceived risks involving a client. Risk-based client due diligence is outlined in the ABA's Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing.

Best practices for screening new clients include:

- have a written policy outlining the types of information that may be obtained in conjunction with the client screening process;
- advise clients of the company's screening policy and that part of the initial engagement process will be to perform a background check (which can be included in the engagement letter);
- obtain written consent to perform background checks (which can be in the engagement letter); and

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- develop a written policy for maintaining the privacy of information and subsequent destruction of nonrelevant information obtained in the screening process.

- b. **Joint Representation Engagement Letter Issues.** An attorney can represent multiple clients with potential conflicts if the lawyer reasonably believes he will be able to provide competent and diligent representation to each provided that each client gives informed, written consent to the joint representation. The following are example provisions for engagement letters, including a description that communications are not confidential as among the multiple clients.

Because we are representing more than one client, it is conceivable that conflicts of interest might arise between you, although we perceive no such conflicts exist at this time. In such event, since we owe each of you an undivided duty of loyalty, we would not be in a position to advocate the position of one of you versus the others, but might be required to withdraw from the engagement, absent your fully informed joint consent to our continuing to represent you. In no event, however, will we represent one of you against the other should disputes arise among you. Only in this fashion can we ensure that our ethical responsibilities to you jointly are met in full. Please initial below to confirm your understanding of this representation.

Initial \_\_\_\_\_

It is important for us to explain to you the ethical obligations imposed on attorneys when we represent more than one client. Since we are representing all of you, each of you is our client. As a result, any communications which one of you like to make to us are not protected by the attorney-client communications privilege from disclosure to the others. That is to say, although all of your communications to us are privileged as far as the outside world is concerned, our Rules of Professional Conduct specifically prohibit us from agreeing with any of you to withhold information from the others if we are representing you jointly. If you have a difference of opinion about the Engagement, we can point out the pros and cons of such differing opinions. However, the Rules of Professional Conduct prohibit us, as the lawyer for all of you, from advocating one of your positions over the others.

Initial \_\_\_\_\_

- c. **Consent For Fee Being Paid By Someone Other Than Client or By One of Multiple Clients.** Particularly in a family representation, the fee may be paid by someone other than the client, or by one of multiple beneficiaries. For example, a parent may agree to pay the fees on behalf of a child. A lawyer may accept compensation from a person other than the client only if the client consents after consultation, there is no interference with the lawyer's independence of judgment or with the lawyer-client relationship, and the client's confidences are maintained. See MODEL RULES OF PROFESSIONAL CONDUCT §1.8(f). The following is an example engagement letter clause for this situation.

California Rule of Professional Conduct 3-310(f) prohibits us from accepting compensation for representation of a client from anyone other than the client without the client's informed written consent. As required under that rule, the payment of our fees, costs, and disbursements will not interfere in any way with our professional judgment or our representation of you, and the attorney-client privilege will be maintained as provided by applicable law below. By your initials, you consent to our representation of all of you under these circumstances.

Initial \_\_\_\_\_



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- d. **Independent Counsel Regarding Engagement Letter.** Advise prospective clients that they may seek legal advice before signing an engagement letter.

## 20. Social Security - Rules of Thumb About Age to Claim Benefits

- a. **Full Retirement Age.** The full retirement age is 65 for those born in 1937 or earlier, increasing in stages from age 65 to 66 for those born in 1938-1942, age 66 for those born in 1943-1954, and increasing in stages from age 66 to age 67 for those born in 1955-1959, and age 67 for those born in 1960 and later.
- b. **Collecting Early.** Retirement benefits can be started as early as age 62, but a permanent reduction in benefits will apply. For example, the percentage of benefits for a worker collecting early whose full retirement age is 66 is as follows: age 62-75%, age 63-80%, age 64-87%, age 65-93%, age 66-100%.

The break-even age for a single person waiting until age 66 (versus age 62) and taking full benefits is age 78. The chance of a 62-year old male living beyond age 78 is 78% and for a 62 year old female the chance is 85%. Waiting until age 66 is a no brainer for most people, unless they cannot obtain work (and are desperate for cash flow for basic support) or have serious health issues AND are single.

- c. **Deferring Starting Benefits Beyond Full Retirement Age.** If benefits do not begin before or at the full retirement age, the annual benefits will permanently be increased, as follows: age 66-100%, age 67-108%, age 67-116%, age 69-124%, age 70 (or later, but there is no reason to defer to a later age)-132%. These are called "delayed retirement credits."

At age 70, the maximum benefit is reached. If a worker defers receiving benefits, the benefits go up 8% per year, so from age 66 to age 70, the benefit would increase by 32% to about \$43,000 per year.

- d. **Impact of Continuing to Work After Receiving Benefits.** If the worker begins receiving benefits before the full retirement age, the worker can earn up to \$15,720/year in 2016 without any reduction in benefits. Earnings above that will reduce the benefits by \$1 for every \$2 earned above that limit.

In the year when the full retirement age is reached (but before actually reaching full retirement age), the worker can earn up to \$41,880/year without any reduction in benefits. Earnings above that will reduce the benefits by \$1 for every \$3 earned above that limit. Only earnings before the month the worker reaches full retirement age are counted for this purpose.

Starting with the month the worker reaches full retirement age, there is no reduction for earnings.

- e. **Retirement Benefit Amounts.** The maximum retirement benefits in 2016 at full retirement age (66) for a person who always earned the maximum in the Social Security system for 35 years are as follows depending on when the benefits begin: age 62 – \$2,102 per month; age 66 – \$2,639 per month; and age 70 – \$3,576. COLA adjustments apply and the amount may change in future years. These monthly amounts translate to annual amounts of \$25,224, \$31,668, and \$42,912.

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- f. **Deciding When to Apply for Benefits.** Factors in the decision of when to begin receiving benefits include the person's health status and life expectancy (e.g., if the person will die at age 64, it would be better to begin receiving benefits at age 62), the need for income, whether the worker plans to work, and the needs of survivors.

The COLA adjustments are made based on the initial base level of payments, so the COLA adjustments magnify the impact of the reduction for early payments. Taking early payments also impacts the level of survivor benefits following the worker's death. Another advantage of delaying payments is that the benefits are based on the 35 top years; dropping out 4 years or more from the late 1970s (when the earnings limit was *much* smaller) and adding the 4 most recent years of earnings results in a higher benefit level.

The most popular age for beginning benefits is age 62 (though that is not the wisest choice, and that percentage is declining). The next most popular age is 66. As suggested in paragraph b above, waiting until age 66 is best for most people.

In making the decision to delay receiving benefits from age 66 to age 70, observe that it takes about 12½ years to recover the four lost years of benefits—14 years taking into account the time value of money. Therefore, the decision to defer benefits means that the worker thinks he or she will live to age 82.5 (or age 84 taking into account the time value of money). Another factor to consider is that if the worker is likely to continue working until age 70, the individual will have a higher base for computing benefits as his or her 35 highest years, thus increasing the "principal insurance amount" even before the "delayed retirement credits" are applied.

The decision of when to apply for benefits also involves other issues, such as spousal benefits. Commercial resources that can assist in maximizing Social Security benefits include reasonably priced software from MaximizeMySocialSecurity.com and SocialSecurityChoices.com and the "AARP Social Security Calculator" available for free at <http://www.aarp.org/work/social-security/social-security-benefits-calculator/>.

Deborah Tedford (Mystic, Connecticut) points out that counter-intuitively, some studies show it is more important for those with fewer savings to delay Social Security than those with substantial assets (and other income). As average Americans age, their savings tend to diminish, and the higher monthly benefits become increasingly important.

- g. **General Rules of Thumb For Decision of When to Begin Benefits.**

- (1) **Earn a Lot.** Earn so much you don't need Social Security.
- (2) **Still Working After Age 62.** Do not claim benefits before age 66 if you are still working and projected wages exceed the annual earnings limit (\$15,720 in 2016).
- (3) **Terminally Ill.** Begin benefits as soon as you can if you are diagnosed terminally ill or are very likely to die within 10 years. ("If wing gliding, claim earlier.")
- (4) **Thirty-Five Years of Qualifying Wages.** If possible, delay benefits until you have 35 years of qualifying wages in the Social Security system.

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(5) **Age 66.** Convincing people to wait past age 66 to begin benefits is difficult, but delaying wages to age 70 is advantageous if the individual anticipates living to approximately age 84.

(6) **Spend Savings If Necessary to Delay.** Spend savings after retirement to permit deferring benefits.

(7) **Unsure Whether to Delay.** If unsure, one possibility is to start benefits at age 68 and split the difference so that you only have to live to about age 78½ to recover the benefits foregone at ages 66 and 67.

(8) **Use It When You Can Enjoy It.** Cash flow at 66 may be a more “valuable” than having additional cash at age 85, if travel or other experiences may no longer be possible at age 85 (i.e., if you can no longer go scuba diving). (“I frankly don’t care if I’m the richest guy in the nursing home.”)

- h. **Taxation of Retirement Benefits.** A portion of Social Security benefits may be subject to federal income taxes. The portion is based on the worker’s “combined income” level, and whether the person files individually, files a joint return, or files married filing separately. The “combined income” is adjusted gross income + nontaxable interest (so investing in tax-free bonds does not help for this purpose) + ½ of Social Security benefits.

For persons filing a joint return, if the combined income of the worker and spouse is between \$32,000 and \$44,000, income tax is paid on up to 50% of the benefits, and if the combined income is more than \$44,000, up to 85% of the retirement benefits are taxable. If some of the benefits are subject to income taxes, the worker can choose to make quarterly estimated payments or to have federal income taxes withheld from the benefits.

If a person will not begin taking distributions from IRAs or qualified plans before reaching age 70 ½ (when the required minimum distributions must commence), that may be a factor in deciding to start receiving Social Security benefits at age 66 if the worker would not have sufficient “combined income” between ages 66-70 to have to pay income tax on 85% of the benefits. (But if a worker has income at that low of a level, it is likely that the worker will have to begin taking distributions from IRAs to have sufficient income for basic support needs.)

- i. **Spousal Benefits.** Very generally speaking, after a worker files for benefits, the spouse can apply to receive a benefit equal to 50% of the amount the worker would be entitled to receive at full retirement age (whether the worker is receiving benefits before or after age 66), but the spousal benefits are reduced permanently if the spouse has not reached his or her full retirement age. However, only one spouse at a time can claim spousal benefits.

After a worker has died, the surviving spouse is entitled to surviving spousal benefits after reaching age 60.

- If the spouse elects to begin receiving survivor benefits before reaching his or her full retirement age, the survivor benefits are reduced (by 1-28.5% depending on how early the election is made).

- If the worker had not started collecting benefits, the widow or widower benefit (assuming it is not reduced because of electing to receive it before the survivor's full retirement age) is 100% of the worker's "primary insurance amount" that would have applied when the worker reached full retirement age.
- If the worker was receiving benefits at the time of his or her death, the widow or widower benefit will be equal to the amount the worker was actually receiving (again, unless reduced because the survivor elects to begin receiving benefits before his or her full retirement age). Thus, one of the advantages for a worker to defer applying for benefits until age 70 is to increase the "two-life annuity" available to the spouses from Social Security.
- The widow or widower will lose the survivor benefits if he or she remarries before age 60 unless the subsequent remarriage ends. Remarriage after age 60 does not impact the entitlement to survivor benefits.

The Bipartisan Budget Act of 2015 impacted the Social Security claiming options of spouses. See Item 2.i of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).

- j. **Divorced Spouses.** Prior divorced spouses are also entitled to spousal benefits. Requirements are that the person was married to the worker for at least 10 years, the divorced spouse has not remarried, both are at least age 62, and they have been divorced at least 2 years. Payments made to a divorced spouse will not impact the amount of benefits payable to the worker or the worker's current spouse (or other divorced spouses of the worker who qualify for divorced spousal benefits).

A prior divorced spouse of a deceased worker is entitled to survivor benefits if the individual was married to the deceased ex-spouse for at least 10 years, if the individual is unmarried or married after age 60, and if the individual is at least age 60.

The spousal benefits and survivor benefits for divorced individuals do not appear on the "Earnings Record" and "Estimated Benefits" statement, and many divorced individuals are not aware of these benefits.

## 21. Elder Law Issues; Avoiding Exploitation

- a. **Power of Attorney and Health Care Directive.** Two of the most important documents for elder planning are the financial power of attorney and health care directive. Consider sending them to applicable family members via email so they will be on their smartphones and available when needed. If the person is still driving, keep the health care directive in the glove box of the car. (The worst place to keep the health care document is in the safe deposit box.)
- b. **Red Flags of Financial Exploitation.** Financial exploitation can take many forms including theft, fraud, identity appropriation, extortion, misuse of a power of attorney, breach of fiduciary duty, or denial of access to funds. Planners representing elderly clients should be sensitive to the following as warning signs of financial exploitation as listed by the Department of Justice:
- withdrawals of money inconsistent with the person's spending habits;
  - withdrawals of money inconsistent with the person's income;

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- will, property title, or valuable asset being bequeathed to a “new” beneficiary;
  - elderly person “cannot find” or “misplaced” valuable personal belongings;
  - unusual credit card activity, or new credit card account;
  - lack of necessities or amenities the person can afford;
  - unfulfilled prescriptions or untreated medical problems;
  - caregiving disproportionate with the elderly person’s income;
  - documents missing;
  - suspicious signatures on documents;
  - financial documents altered;
  - acquaintance takes up residence with the elderly person;
  - mail redirected;
  - prepaid services not delivered; and
  - incessant phone calls to the elderly person.
- c. **Meet With Client Alone.** Meet with the client alone (or at least telephone the client later to talk with the client apart from other family members). The speaker relayed an actual example of a situation in which, a daughter brought mom to visit about estate planning. She was having the onset of Alzheimer’s. The attorney asked if he could meet alone with mom and the daughter refused, saying “mom and I do everything together.” Mom agreed, “I’d like her in the room.” That one daughter was her main caregiver. Mom wanted to leave the estate to that daughter, and that daughter would be the executor, agent under the power of attorney, agent under the health care directive, etc. Several days after the meeting, the attorney called mom by telephone. She was very glad he called. The daughter had been estranged and just reappeared in her life. She was feeling badgered but did not want to tell her other children because she didn’t want her children to be pitted against each other. Mom eventually used a fairly “vanilla” will, using an institutional trustee.
- d. **Example of Impact That Planner Can Have on Elderly Clients.** The speaker read an actual letter that he received from an elderly client that was included with the check to pay the speaker’s bill for services:

Dear Stuart. You knew that I am not the wrinkled bent over person as I now appear to be. As you said, I deserve dignity and respect. Thank you for finding me in me and making sure I got to do what I wanted to do. Mabel V. Nelson

## 22. Electronic Wills Act

Traditionally, wills must be on paper, either typed (or printed) or handwritten. Nevada was the first state to adopt a statute recognizing electronic wills. NEV. STAT. ANN. §133.085(1)(a) (2016). Recently introduced Florida S.B. 206 and H.B. 277 allows persons to execute wills electronically without the physical presence of a witness or an attorney.

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At least three other states will likely introduce similar legislation in 2017. A growing trend of interest is appearing in this topic.

The Joint Editorial Board for the Uniform Trusts and Estates Act has recommended that the Uniform Law Commission form a drafting committee to address proposed uniform legislation governing electronic wills.

One issue to be addressed is how an electronic document will be authenticated. For example, the Nevada statute requires the testator's electronic signature and at least one "authentication characteristic," which the statute defines as "a reprint, a retinal scan, voice recognition, facial recognition, a digitized signature or other authentication using a unique characteristic of the person."

The Florida bill is simpler, requiring that the will exists in an electronic record, is electronically signed by the testator in the presence of either a notary public or at least two attesting witnesses, and is electronically signed by the notary public (and accompanied by a notary public seal) or both of the attesting witnesses "in the presence of" the testator and, in the case of witnesses, in the presence of each other. Individuals are deemed to be "in the presence of" each other if they are in the same physical location or in different physical locations that can communicate with each other by live video and audio conference (meaning they could be present with each other by Skype). However, another requirement in the current amended version of the bill is that either the notary or both attesting witnesses must physically be in the "same room" as the testator. The signature requirement of any individual may be satisfied by an electronic signature. For an electronic will to be self-proved, a qualified custodian must be designated to control the electronic record, and the electronic will at all times must have been under the control of a qualified custodian before being reduced to the certified paper original that is sought to be probated.

Concerns will also have to be addressed about the safety, confidentiality, and the possibility of fraudulent tampering.

### **23. Reporting Charitable Gifts on Gift Tax Return**

Charitable gifts (even if less than the annual exclusion amount) are technically required to be reported on gift tax returns. Page 2 of the Form 709 Instructions states: "If you are required to file a return to report noncharitable gifts and you made gifts to charities, you must include all of your gifts to charities on the return."

If a donor has not previously reported charitable gifts on gift tax returns and the failure to do so was not willful, penalties are unlikely. (Penalties would be based on the amount of tax, but that is likely zero in any event.)

A reason for reporting charitable gifts on gift tax returns, even if penalties are not a concern, is that if more than 25% of a donor's gifts (charitable and non-charitable) are not reported on Form 709, the period of limitations for assessments is extended from three to six years. Reg. §1.6501(e)-1(b)(1). This is particularly important for gift tax returns reporting GRATs. Unless other substantial gifts are made during the year, the taxable gift resulting from a gift to a GRAT is likely very low (perhaps even \$100 or less, despite the size of assets transferred to the GRAT). The omission of even small charitable gifts could cause the 6-year period of limitations on assessment of gift taxes to apply.

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## 24. Trust as Owner of Another Trust, PLR 201633021

Letter Ruling 201633021 approves the fascinating concept of one trust being treated as the owner of another trust for income tax purposes under §678(a). In this ruling, Trust 1 and Trust 2 had the same beneficiaries and same distribution provisions. Trust 1 had the power to withdraw the income from Trust 2 each year, which power lapsed at the end of each calendar year.

Section 678(a) provides that a person other than the grantor shall be treated as the owner of any portion of the trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of Sections 671–677, subject a grantor of a trust to treatment as the owner thereof.

The IRS ruled that because of Trust 1’s withdrawal right, Trust 1 was the deemed owner of the portion of Trust 2 over which it held the withdrawal power. Because Trust 1 had the power to withdraw the income of Trust 2, which Trust 2 defined as capital gains, as well as dividends, interest, fees, and other amounts characterized as income under §643(b), Trust 1 effectively was treated as the deemed owner of all the taxable income of Trust 2. Reg. §1.671-2(e)(6)Ex. 8 is consistent with this result.

This result opens the possibility of having sale transactions between the trusts that would not be treated as taxable transactions. (For an example of possible applications with GRATs, see Items 3.f and Item 11.d.(5) above.)

## 25. Intergenerational Split Dollar Life Insurance Plan Qualified for Economic Benefit Regime Under Split Dollar Regulations, *Estate of Morrissette v. Commissioner*

- a. **Synopsis of *Estate of Morrissette v. Commissioner*.** The Tax Court, in a “regular” opinion of the full court, approved an intergenerational split dollar life insurance arrangement in which Mrs. Morrissette (actually her revocable trust) paid large lump sum premiums (\$29.9 million) for Dynasty Trusts to purchase universal life insurance policies on the lives of her three children. Under the split dollar agreement, as each of the children died, the revocable trust was entitled to receive the aggregate premiums paid (without added interest) on the policies on that child’s life (or the cash surrender value of such policies, if greater [but the cash values may be lower than the aggregate premiums paid, because the cost of insurance and other costs of maintaining the policies in force would be charged against the policies each year]). Following Mrs. Morrissette’s death, her estate included her reimbursement rights under the split dollar arrangements in her estate, at a value of about \$7.5 million (compared to the \$29.9 million lump sum premiums she had paid), in light of the fact that her revocable trust would not receive the payments for many years in the future (as her children died—actuarially expected to be about 15 years later).

The court granted partial summary judgment, holding that the technical requirements in the regulations for applying the economic benefit regime were satisfied. The court’s analysis waded through the hyper-technical details of the split dollar regulations. The central issue under the court’s analysis is its conclusion that the

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Dynasty Trusts had no current access to the cash values of the policies and received no additional economic benefit other than current life insurance protection. *Estate of Morrisette v. Commissioner*, 146 T.C. No. 11 (2016) (appealable to Fourth Circuit).

The court did not address the valuation issue or other issues raised by the IRS. (The IRS maintained in the Notice of Deficiency that the full \$29.9 million premium advance should be treated as a gift.) The other issues will be addressed following this partial summary judgment decision. For a detailed discussion of the analysis in *Morrisette*, see Item 27.b-e of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).

b. **Brief Background About Discount Intergenerational Split Dollar Insurance.**

Under traditional split dollar arrangements, a donor funds premiums on a policy on the *donor's* life, and the premium advances are repaid at the donor's death from the policy death proceeds. In contrast, under intergenerational split dollar arrangements, a parent pays premiums on a policy insuring a *child* (or *grandchild's* life), and the premium advances are not repaid until the insured's death, which could be decades in the future. If the reimbursement right is transferred by the parent (by gift or sale or as an asset of the donor's estate at her death), a substantial discount may apply in determining the *present* value of the reimbursement right, which might not be repaid for decades. (The *present value* of the right to a set dollar amount, to be paid decades in the future, would obviously be much smaller than the aggregate payment that would be made many years in the future.)

Taxing intergenerational split dollar insurance under the economic benefit regime is helpful in supporting a substantial discount on the value of the receivable; under the economic benefit regime the parent just receives the aggregate premiums paid or cash surrender value if greater (and is treated as making a transfer each year of the current value of life insurance coverage), but under the loan regime the reimbursement right would be for the premiums paid *plus interest* that would accrue over the many years before the repayment is made.

- c. **Planning Considerations.** For an overview of planning issues regarding intergenerational split dollar life insurance, see Lee Slavutin, *A Post-Morrisette Roadmap for Drafting Intergenerational Split Dollar Agreements*, LEIMBERG ESTATE PLANNING NEWSLETTER #2414 (May 12, 2016); Alan Jensen & R. Brent Berselli, *Estate of Morrisette: Unfinished Business*, LEIMBERG ESTATE PLANNING NEWSLETTER #2418 (May 23, 2016) (hereinafter "Jensen & Berselli, *Unfinished Business*"); Lee Slavutin & Richard Harris, *Intergenerational Split Dollar Life Insurance; What Can We Learn from Morrisette, Levine and Neff?*, LEIMBERG ESTATE PLANNING NEWSLETTER #2443 (August 9, 2016); Espen Robak, *Intergenerational Split Dollar Valuation Issues*, LEIMBERG ESTATE PLANNING NEWSLETTER #2444 (August 9, 2016).

(1) **Significance; Only One Narrow Issue in *Morrisette*.** *Morrisette* is important because it is the first court case addressing intergenerational split dollar insurance, and it is a taxpayer victory by the full Tax Court. But the court addresses only one narrow issue (on the taxpayer's motion for partial summary judgment as to that narrow issue), and the IRS is no doubt advancing a variety of other issues in the case (in addition to the valuation issue).



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Many questions remain regarding the tax treatment of intergenerational split dollar insurance; it is not widely used (just by some very wealthy families), and the IRS may continue to address other ways to fight the overall result of a transfer with a huge discount (the IRS's brief characterized the plan as an effort to "minimize the taxable estate"). Nevertheless, this initial decision is a significant development regarding intergenerational split dollar agreements.

(2) **Other Potential IRS Attacks.** A variety of potential issues, other than whether the economic benefit regime applies, exist regarding intergenerational split dollar arrangements. Some of these other issues are:

- Treatment of insurance coverage following premium payer's death;
- Section 2703 – (the taxpayers in *Morrisette* have filed a motion for partial summary judgment that §2703 does not apply);
- Sham transaction; lack of business purpose.
- Step transaction – this is the position that it is taking in *Estate of Marion Levine v. Commissioner*, T.C. No. 9345-15 (petition filed April 8, 2015) ("transfer ... constituted gifts ... in a series of interrelated steps with a value equal to the cost of the ... premiums paid"); the Tax Court entered summary judgment in favor of the taxpayer on July 13, 2016 in *Estate of Levine*, resulting in no gift tax deficiency or penalties, on the basis of the *Morrisette* opinion;
- Modification under the split dollar regulations;
- Sections 2036 and 2038; and
- Duty of consistency.

For a discussion of the IRS attacks under each of these arguments, see Item 27.f.(2) of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).

(3) ***Estate of Cahill v. Commissioner.*** A new case that has been filed in the Tax Court is illustrative of additional issues that arise with intergenerational split dollar insurance. *Estate of Cahill v. Commissioner*, T.C. No. 10451-16 (petition filed May 3, 2016). Issues raised by the IRS in that case include:

- Property paid to the trust (to pay premiums) is included in the decedent's gross estate under §§2036(a)(1) and 2036(a)(2), and the transfer was not a bona fide sale for adequate and full consideration;
- Certain provisions of the split-dollar agreement constitute a restriction on the right to use or sell the decedent's property, or an option, agreement, or other right to acquire or use decedent's property at a price less than fair market value under §2703;
- Property paid to the trust is included in the gross estate under §2038; and

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- Under §2043, the excess of the fair market value at the time of death of property otherwise included under §2038 or §2035 over the value of the consideration received by decedent was included in the gross estate.

The trial is set for February 27, 2017.

(4) **Valuation of Receivable.** The court in *Morrisette* made clear that it was not addressing the value of the receivable in the partial summary judgment decision; that will be addressed subsequently. However, at least one commentator predicts that “*Morrisette* will not proceed to a decision on the merits of the valuation of the [split dollar] receivable. There is simply too much at stake to be wrong—for the taxpayer and the IRS. We faced a similar dilemma and ultimately settled on a discount of 35% as opposed to our claimed 95%.” See Jensen & Berselli, *Unfinished Business*.

In the case referenced by Jensen and Berselli, G-1 advanced premiums to life insurance trusts to purchase life insurance on the lives of G-1’s children (G-2). The split dollar receivables were reported on the decedent’s estate tax return on the basis of independent valuations of the split dollar receivable, which considered the decedent’s restricted access to repayment as well as the actuarial life expectancy of each of the insureds. The receivables were reported with a 95% discount—and the parties settled at a 35% discount.

In *Cahill*, the values reported on the estate tax reflected about a 98% discount compared to the value asserted by the IRS. An independent appraiser (WTAS, LLC, now Anderson Tax) valued the receivable using the discounted cash flow method using a discount rate of 15%.

Some planners have reported settlements with discounts of 65%-90%.

One appraiser examines empirical data from lottery prize transactions, private note transactions, structured settlement transactions, and life settlement transactions to determine an appropriate discount factor for valuing intergenerational split dollar loans. He observes that one company that manages a portfolio of 600 policies acquired in life settlement transactions reports discounts rates ranging from 15.0% to 24.5%, with a weighted average discount rate of 17%. Espen Robak, *Intergenerational Split Dollar Valuation Issues*, LEIMBERG ESTATE PLANNING NEWSLETTER #2444 (August 9, 2016).

(5) **Loan Regime Arrangements.** A general trend is emerging among planners using intergenerational split dollar to prefer the loan arrangement for various reasons. See Lee Slavutin & Richard Harris, *Intergenerational Split Dollar: What Can We Learn from Morrisette, Levine and Neff?*, LEIMBERG ESTATE PLANNING NEWSLETTER #2443 (August 9, 2016) (loan treatment can be assured, loan can be for life of insured allowing lock in of low interest rate, easier to understand, all variables locked in at outset, large history of loan receivables being valued at a discount, and no report of any intergenerational split dollar loan regime cases being audited). The IRS so far has not been auditing loan regime arrangements. The discounts may not be as large as under the economic benefit regime, but planners suggest that significant advantages may still be available. (For example, significant discounts may still apply because the interest rate on the loan may be much lower than the discount rate that an appraiser

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will apply in valuing the note.) One planner reports settling an intergenerational split dollar loan under the loan regime with a 65% discount. Other planners acknowledge that discounts are lower under the loan regime approach, but only nominally so.

(6) **Sale of Receivable.** A sale of the receivable during the donor's life may reduce the likelihood of the IRS raising other arguments summarized in Subparagraph (2) above on an audit of the donor's estate tax return if the return merely includes cash or another note that makes no reference to a life insurance policy.

(7) **Summary by Steve Leimberg.** The following excellent summary by Steve Leimberg summarizes current practices and suggests best practices from a planning standpoint.

In my opinion the summary judgment granted the taxpayer in *Morrisette* was a relatively minor issue that the IRS had very little hope of winning. The pre-eminent issue concerns the appropriateness of the discount taken. That issue has yet to be decided, and my guess is that it's likely that issue isn't settled and we will see no formal opinion on the valuation issue. Having said that, my understanding is that the other [generational split dollar] cases I've been following have been settled on this issue (sometimes with pretty generous results). I've heard there are around 20 or so [generational split dollar] cases currently under audit, with several on the tax court docket. All of these cases currently under audit were apparently done using the economic benefit regime. (It does not appear the Service is challenging cases done under the loan regime.) ... That makes the safer course of action use of the loan regime.

Inter-generational split-dollar may be troublesome to some insurance carriers — mainly because of the persistency risk. As we've seen so many times in the past, insurance purchases that are not intended to meet a legitimate life insurance need of the younger generation, but rather, are designed to move money from the older generation to the younger generation with minimal transfer tax consequences generate problems. In too many instances, the funds are being paid into the policy as a single premium (even ignoring the fact that putting a collateral assignment on a MEC policy is a bad idea due to Code sections 72(e)(10) and 72(e)(4)). In addition, the policies were designed to have a high early cash surrender value, oftentimes utilizing riders to accomplish this. Once the split dollar receivable was transferred (either by gift or at death) and the discount taken, then the policies were generally immediately surrendered for their cash value by the younger generation. This surrender generally took place within 2-5 years. ... The persistency risk is that a carrier's breakeven point may not be until year 8 or 9, and carriers are in business to make a profit, not merely to break even. So the [generational split dollar] arrangement described above would be bad business" for carriers, and clients and producers are profiting using a "sham transaction" to the detriment of life insurance carriers.

Bottom Line:

I believe there is still significant tax and legal risk involved in inter-generational split-dollar. I do not believe *Morrisette* changed that. I do feel that risk can be alleviated somewhat by using the loan regime, holding the receivable until the death of the second generation rather than gifting it, structuring the policy as a non-MEC, and ensuring that there is a legitimate need for the insurance.

Caution: Even those precautions may not be adequate in situations where the arrangement is entered into primarily as a means to transfer funds from one generation to the next with minimal transfer tax consequences and the intent is to surrender the policy after the transfer of the split dollar receivable. Such abusive uses of [generational split dollar] remain subject to IRS attack as a sham transaction. In addition, insurance carriers generally have no appetite for such bad persistency business and are increasing screening for such arrangements in an attempt to prevent the use of their products with them.

Comments by Steve Leimberg appearing in Jensen & Berselli, *Unfinished Business*.

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## 26. ING Trusts – 2016 Letter Rulings

- a. **Overview.** Incomplete Non-Grantor (“ING”) Trusts are trusts used to avoid state income tax by having the trust situated in a jurisdiction that will not tax the accumulated and capital gains income in a non-grantor trust. (Income of a grantor trust would presumably be subject to tax in the state of the grantor’s residence.) The trust is merely designed to avoid state income tax, and the donor most certainly does not want to risk having to pay federal gift taxes (at a 40% rate) to have an argument of avoiding state income taxes at a much lower rate.

The ING trust typically allows a distribution committee to make distributions to the beneficiaries, including the grantor. The distribution committee typically consists of several beneficiaries other than the grantor. The trust avoids grantor trust treatment under §674 by requiring the consent of an adverse party to all distributions during the grantor’s lifetime. The grantor retains a right to veto distributions to other persons during the grantor’s life and retains a testamentary limited power of appointment to cause the gift to be incomplete. The IRS has issued favorable private letter rulings regarding a variety of ING structures.

For various resources about ING trusts, *see also* Akhavan, *DINGing State Income Taxes in Artwork Transactions*, 153 TR. & EST. 31 (June 2014); Blattmachr & Lipkind, *Fundamentals of DING Type Trusts: No Gift Not a Grantor Trust*, 26 PROB. PRACT. RPTR. 1 (April 2014); Pulsifer & Flubacher, *Eliminate a Trust’s State Income Tax*, 145 TR. & EST. 30 (May 2006); Schaller, *Reduce State Tax with DINGs, NINGs, WINGs, and Other ThINGs*, 41 EST. PLAN. 23 (April 2014); Schoenblum & Schoenblum, *Avoiding State Income Tax With the Right Kinds of Trusts*, 41 EST. PLAN. 19 (May, 2014); Steiner, *The Accidentally Perfect Non-Grantor Trust*, 144 TR. & EST. 28 (Sept. 2005).

For a detailed discussion of the reasoning in an example ING ruling, see Item 37 of the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at [www.Bessemer.com/Advisor](http://www.Bessemer.com/Advisor).

- b. **2016 Letter Rulings.** Various letter rulings in late 2015 and in 2016 granted favorable ING rulings, including that the trust is a non-grantor trust, that the contribution to the trust is not a completed gift by the donor, that distributions will not be treated as a gift by distribution committee members, and that distribution committee members will not have a general power of appointment over the trust assets. PLRs 201550005-201550012, 201613007, 201614006-201614008, 201636029 & 201642019.
- c. **PLR 201642019; Less Than Two Distribution Committee Members.** Letter Ruling 201642019 revoked Letter Ruling 201426014. The trust in that ruling stated that both the children are no longer serving as members of the Distribution Committee or if fewer than two members are serving, the trust property will be distributed to the grantor and the trust will terminate. The IRS now declares that this constitutes a reversionary interest under §673, and if a greater than 5% probability exists that the Distribution Committee could drop below two, the trust is a grantor trust (even when the Committee has more than one member).

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A similar approach is often used in ING trusts because Distribution Committee members do not have a general power of appointment if their interests are substantial and adverse to each other, but if there is only one member, that would no longer be true.

To avoid the problem raised by this ruling, the trust could be structured to provide either that (a) the Distribution Committee must always have more than two members, and that any vacancy in one of the positions be filled promptly; or (b) if there is ever only one member of the Distribution Committee, no distributions can be made to anyone until the membership of the Distribution Committee is increased to two or more.

The changing position of the IRS in this ruling is an example of why some planners will not structure an ING trust without first getting a favorable Letter Ruling.

## **27. New Procedure for Release of Special Automatic Estate Tax Lien**

The general estate tax lien arises under §6324(a) on all property includible in the decedent's estate for 10 years. The general estate tax lien does not have to be recorded; it is automatic. If the collateral for the lien is property of the estate, the automatic estate tax lien under §6324(a) on that property is extinguished by the special estate tax lien for §6166 deferred tax under §6324A.

For PROBATE assets, property that is purchased or transferred is still subject to the lien in that person's possession, except that if property is transferred to a purchaser or holder of a security interest and if the executor has been discharged from personal liability for the estate tax under §2204, the lien no longer applies to the transferred property but the lien attaches to the consideration received from the purchaser. §6324(a)(3). For that reason, any purchaser of probate property should request documentation that the executor has been discharged from personal liability under §2204 or request that the IRS release the lien.

For NONPROBATE assets, the rules are quite different, as illustrated in Legal Advice Issued by Field Attorneys (LAFA) 20061702F. Nonprobate property transferred to a purchaser or holder of a security interest is no longer subject to the lien; however a like lien attaches to all of the transferor's property. §6324(a)(2). The specific issue in LAFA 20061702F was whether pledging property was a "transfer" for purposes of this special rule that divested transferred property of the lien. The LAFA held that it was. It pointed out, though, other special rules that apply for nonprobate property under §6324(a): (1) The beneficiary is personally liable for the estate tax; (2) The lien remains to the extent that the value of the collateral exceeds the balance of the loan to the lender; and (3) There is a lien against the beneficiary's property.

***New Procedure Instituted in 2016.*** Significant changes in the procedures for estate tax lien discharges were instituted in 2016. The IRS Collections Advisory Group is now handling applications for certificate of discharge of property subject to the estate tax lien; these were formerly handled by the local IRS Estate and Gift Tax Groups. Under the new procedures all sale proceeds must be paid to the IRS or placed in escrow. The only permitted reductions seem to be for amounts needed to satisfy mortgages and "reasonable" selling expenses.

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The IRS has issued a revised Form 4422, Application for Certificate Discharging Property Subject to Estate Tax Lien, which must be submitted to the IRS along with the supporting documents described in the instructions to Form 4422. (The form is dated September 2016.) The attorney will need to supply the IRS with a title insurance commitment showing the legal description. The instructions provide: "If the property consists of real estate, attach a separate legal description and a preliminary title report for each parcel." The estate will have to produce evidence that the selling price is a fair price, such as with an appraisal or perhaps a letter from a real estate broker who is knowledgeable about the market and comparable properties. The instructions to Form 4422 say to "show the value of the property and the basis of the valuation."

If an escrow approach is used, the IRS will supply an escrow agreement (and it will not agree to any changes to the agreement). The IRS must approve the escrow agent, and one of the requirements is that the escrow agent be bonded. Provide the IRS with a draft of the closing statement showing the net sale proceeds, so the IRS manager can prepare the escrow agreement. The escrow agreement will reflect the legal description of the property for which the discharge is requested, and the net sale proceeds. The IRS will fax (but not email) the escrow agreement, which must be signed by the personal representatives, the escrow agent, the IRS manager in charge of this new process, and that IRS manager's supervisor (and the manager and supervisor are located in different cities). The process of finalizing the escrow will take some time; do not wait until close to the closing to begin the process.

The IRS will initially issue a conditional commitment, which will allow the sale to close. The actual certificate discharging the lien is not issued until the IRS has confirmation that the funds are in the possession of the escrow agent.

If the escrow approach is used, an estate tax closing agreement is required to obtain the release of the funds. Query whether a transcript with the code "421" will suffice for this purpose? Notice 2012-12 suggests that it would. (See Item 5.e above.)

This summary includes information provided by Laird Lile (an attorney in Naples, Florida) in a Florida Bar Real Property Probate and Trust Law Section newsletter and in subsequent updates. He indicates that the IRS manager in charge of this new process (as of March 7, 2017) is Kim Harris (904-661-3276).

IRS officials have indicated informally that the shift of the lien release process to the IRS Collections Advisory Group was merely a resource allocation decision with no intention to change the existing procedure. The changed procedures may simply reflect the general lien release procedures used by the Collections Group. The December 29, 2016 Federal Register published a request for comments on Form 4422; however, the request is specifically just about the form itself and whether information required by the form is necessary, and not about the lien release procedures. An IRS official who is looking at the revised policy has recently asked Randy Harris (New York) to supply examples of estates that have had problems with this revised procedure. The IRS apparently is considering issuing relaxed rules, allowing relief in some situations (such as if no estate taxes are due), and may issue a revised Form 4422 with revised instructions.

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**Planning Tip:** For older clients who anticipate that real estate will be sold after their deaths to pay administration expenses or state taxes, consider contributing the real estate into a single member LLC prior to death. The estate tax lien applies to the membership interest in the LLC, not to the underlying real estate.

## **28. Valuation—Appeals Court Remands Case for Further Company Valuation Review; Tax Court Must Make Its Own Determination of Value If It Finds the IRS Valuation was Arbitrary and Capricious Due to Flaws in Its Expert’s Appraisal, *Cavallaro v. Commissioner***

In *Cavallaro v. Commissioner*, T.C. Memo 2014-189 (Judge Gustafson), the parents’ company manufactured tools. The company developed a special prototype tool, with which it had limited success. At some point the parents’ adult sons developed an interest in the special tool, and worked to improve and market it. The sons formed their own company to sell this product. Some years later, the two companies were merged, and the issue was whether the sons received too large an interest in the merged company. The IRS maintained that the sons’ company had a pre-merger value of zero and that each of the parents made gifts of \$23,085,000 to their sons as a result of the merger. The court upheld the IRS position, reasoning that there was no evidence of arm’s length negotiations between the two companies. A key fact was that the parent’s company owned the technology for the special tool and there was no documentation that the technology had ever been transferred to the sons’ company. The estate was not able to meet its burden of proof to establish a lower gift amount. The court refused to hear challenges to the IRS’s appraiser’s methodology on the grounds that the taxpayers could not show the correct amount of their tax liability, despite the fact that the IRS appraiser concluded that the sons’ company had a substantial pre-merger value, which resulted in the IRS changing its position at trial to concede that the sons’ company had some pre-merger value. The court rejected accuracy-related penalties, finding that the taxpayers had reasonably relied on the advice of their professional advisors. (Interestingly, *Cavallaro* arose from an income tax audit. The income tax examiner referred the case to gift tax examiners.)

The First Circuit Federal Court of Appeals has remanded the case to the Tax Court. The appellate decision rejected the taxpayers’ argument that the burden of proof shifted to the IRS, but agreed with the taxpayers that the court should re-evaluate whether the accountant that the IRS used to value the companies used flawed methods. “If the Tax Court determines that the Commissioner’s assessment was arbitrary, then it must determine the proper amount of tax liability for itself.

The Cavallaros attempted to show that the Commissioner’s valuation was “arbitrary and excessive” by challenging Bello’s [the accountant used by the IRS to value the companies] methodology, but the Tax Court refused to hear those challenges on the grounds that, even if the Cavallaros were right, they could not show the correct amount of their tax liability. This runs squarely against the Supreme Court’s holding in *Taylor* [293 U.S. 507 (1935)].

The Cavallaros should have had the opportunity to rebut the Bello report and to show that the Commissioner’s assessment was “arbitrary and excessive.” If they succeeded in doing so, the Tax Court should have then determined for itself the correct amount of tax liability rather than simply adopting the Commissioner’s position ...

... The court is free to accept in whole or in part, or reject entirely, the expert opinions presented by the parties on the subject. [Citations omitted.] Further, the court may take new evidence, including a new expert valuation.

*Cavallaro v. Commissioner*, Cause Nos. 15-1368 & 15-1376 (1st Cir. Nov. 18, 2016).

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## 29. Valuation; Approval of Extremely Broad Summons Requesting Information About Prior Clients and Appraisal Work Files, *U.S. v. Clower*

The IRS investigated whether an appraiser may have violated Internal Revenue Code provisions in connection with his involvement in conservation-easement partnerships or arrangements, or while preparing appraisal of conservation easements. The IRS Revenue Agent averred that the IRS had identified “at least one conservation-easement appraisal prepared by Clower which appears to be overvalued or improper,” and sought information regarding whether the appraiser may be subject to civil penalties under §§6694, 6695, 6700, 6701, 6707, or 6708. In May 2015, as part of that investigation, the IRS issued an administrative summons to the appraiser pursuant to 26 U.S.C. §7602 requesting production of the following:

- (1) All marketing documents for the valuation of conservation easements, including but not limited to advertisements, brochures, and flyers.
- (2) All documents reflecting any of the customers for whom [he] prepared or approved appraisal during the period beginning January 1, 2010 through the present that were completed for the purpose of valuing real property for estate, gift, charitable, conservation easement or historical easement purposes. ...
- (3) All appraisal work files for the purpose of valuing real property for estate, gift, charitable, conservation easement or historical easement purposes for the period January 1, 2010 to the present ...
- (4) All correspondence including emails and facsimiles related to appraisals completed for the purposes of valuing real property for conservation easement or historical easement purposes ... from January 2010 to present.

This extremely broad request includes customer lists, all appraisal work files and all emails related to appraisals of real property for estate, gift, charitable or conservation easements purposes for six years. The appraiser contested the summons “because it sought any type of appraisal, not just his appraisal of conservation easements. He was also concerned that, if the IRS were to contact all of his clients, his business would dry up.” The magistrate judge asked the government clarify the scope of the documents, and the government limited the request to appraisals of conservation or historical easements for estate, gift, or charitable purposes.

The magistrate judge recommended that the IRS’s summons request be granted and the eleventh circuit court of appeals affirmed, because the four requirements outlined in *U.S. v. Powell*, 379 U.S. 48 (1964) were satisfied: (1) the investigation will be conducted pursuant to a legitimate purpose, (2) the inquiry must be relevant to the purpose, (3) the information sought is not already within the IRS’s possession, and (4) the administrative steps required by the Code have been followed. *U.S. v. Jim R. Clower*, No. 16-13039 (11th Cir. Dec. 22, 2016) (unpublished).

One commentator has criticized the broad power of such “fishing expeditions” that could coerce appraisers regarding their appraisals:

While I applaud the IRS in fighting tax fraud, as a valuation expert, the breadth and volume of information that can be requested by the IRS at their whim, and without the requirement to prove fraud, is troubling. This sweeping power could be used to coerce appraisers into providing opinions that would meet with the IRS’s arbitrary acceptance, as opposed to being wed to fair market value principles. Lance S. Hall, *IRS “Fishing Expeditions” have New Clout*, THE FMV VALUATION ALERT (December 28, 2016).



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### 30. Interesting Quotations

- a. **Legislation.** “The concept of portability was simple. It could have been simple. But it is legislation; ergo it is not simple.” — Howard Zaritsky
- b. **Repeal Prediction.** “I’ve been making predictions about the estate tax for 40 years. So far I’ve been incorrect. So, I’m due. I think the estate tax will be repealed sometime in late 2017, but it will have a 10-year ‘sunrise’ – with the estate tax popping up again in 10 years.” — Howard Zaritsky
- c. **REAL Problems.** “If a client says ‘my spouse will die first,’ you may have bigger problems than tax planning.” — Howard Zaritsky
- d. **Diversification.** An investment adage is “You get rich by over-concentration. You stay rich by diversification.” — Howard Zaritsky
- e. **Prince Charles Effect.** The “Prince Charles Effect” is that wealthy people live longer than the general population. The life expectancy statistics for wealthy people versus the general population are 91.9 vs. 81.2 years for females, and 88.8 vs. 76.4 years for males. — Richard Franklin and Lester Law
- f. **Life Uncertainties.** The old Yiddish proverb is that “Man plans, God laughs.” — Dennis Belcher
- g. **Legislative Problems.** “Former Representative Bill Archer once told Stacy Eastland that when a member of Congress can cite a Code section by number, you know there is a problem.” — John Porter
- h. **Better or Worse?** The House Republican tax reform Blueprint for Tax Reform is entitled “a Better Way.” “Of course, no one proposes ‘the Worst Way’.” — Ron Aucutt
- i. **Uncertainty at the Diamond.** The (now retired) baseball pitcher, Joaquín Andújar said ““You can sum up the game of baseball in one word: ‘You never know.’” — John Porter (Another classic Andújar quote: “That’s why I don’t talk. Because I talk too much.”)
- j. **SPCA.** In discussing a recent case involving the Society for the Prevention of Cruelty to Animals, Prof. Sam Donald observed, “Just to be clear, the SPCA is taking the lawyer to the doghouse.” — Sam Donaldson
- k. **Every Man’s Greatest Fear.** Every man’s greatest fear is that his surviving wife will massively upgrade to someone who will bring everything the first husband didn’t – hair, a chiseled body that doesn’t have to be covered by a sweater vest just to have the dignity to speak in public, someone who’s handy around the house, someone who’ll do things without having to be asked to help-because he wants to help and wants to participate and cares about co-responsibility. Perhaps I’m projecting.” — Sam Donaldson
- l. **Which of Those 1014(b) Subparagraphs Is It?** Section 1014(b)(9) is the subparagraph giving a basis adjustment for property in the gross estate. Prof. Sam Donaldson adds this memory device: “It is 1014(b)(9) – not “malignant,” but “b-9.” —Sam Donaldson

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- m. **The Doctor Is In.** The *Holliday v. Commissioner* case involved a decedent with one son who was a doctor. “We’ll refer to him as Doc Holliday.” —Sam Donaldson
- n. **Tenth Circuit.** “The IRS did not appeal *Wandry*. The appeal would have been to the Tenth Circuit. The Tenth Circuit is based in Denver, and Colorado had just legalized marijuana. Treasury was not going to take a chance with what the judges there were going to say, particularly if oral argument wasn’t scheduled until late afternoon.” — Sam Donaldson
- o. **Political Surprises.** “We are in a time of tremendous political surprise. Paradigms have shifted, landmarks have been moved, all baselines are obsolete, and all predictions have been wrong.” —Ron Aucutt
- p. **Retroactive Tax Legislation.** “If the estate tax is repealed retroactive to January 1, 2017, and if it is accompanied by carryover basis or realization at death, look out. Someone is bound to think of litigating that and some folks will just be dying to do it.” —Ron Aucutt
- q. **Tax Law Sunsets.** “Sunsets are pretty in Florida, they are ugly in D.C. Remember 2001 and 2010. That was chaos.” —Ron Aucutt
- r. **A Few Democrats.** Having some degree of bipartisanship in Congressional action is a good thing. “A few Democratic votes would be good cosmetics, but too many means giving up too much control of the product.” —Ron Aucutt
- s. **Tax Predictions.** “All predictions have been wrong.” — Ron Aucutt
- t. **From Simple to Complex.** “This thing has more layers to it than the typical episode of *Desperate Housewives*.” — Sam Donaldson
- u. **Fifth Circuit.** “The Clayton QTIP comes from the Fifth Circuit Court of Appeals, where etched on the courthouse steps it says ‘Taxpayer Welcome.’ You don’t lose in the Fifth Circuit. As a taxpayer, there is a constitutional right to win in the Fifth Circuit. Guns and victory over the IRS are guaranteed in the Fifth Circuit.” —Sam Donaldson
- v. **Surviving Spouse “Over-life.”** “The credit shelter trust works better if the surviving spouse will live a long time, but a significant chunk of surviving ‘spise’ die within a year. For others, ‘Cry Sweet Freedom Baby.’ The remote is mine. I can delete Scandal and Gray’s off the DVR. I can put up the mounted bass. I can live life to the fullest now – and live another 40 years.” —Sam Donaldson
- w. **Why Is It Called a Trust?** “Why is it called a trust? If I don’t trust the surviving spouse, then I need a trust.” — Sam Donaldson
- x. **Memory Device for Remembering the 2017 Exemption Amount.** “The estate tax exemption is \$5.49 million in 2017. I don’t know why it couldn’t have been an even \$5.5 million. Instead we do Walmart pricing of it.” — Sam Donaldson
- y. **SNeAKY §2704 Proposed Regulations.** “I worry there is a snake in the grass in the section 2704(b) proposed regulations. The question is whether it’s a garter snake or rattlesnake.” —Dennis Belcher
- z. **Too Late?** “The all-to-often client question ends with ‘or am I too late.’ Any time you have to ask that question, you probably already know the answer. You just want the

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doctor to tell you that you are dying instead of diagnosing yourself.” — Sam Donaldson

- aa. **Priorities.** Where is estate tax repeal in the order of priorities for tax reform? Sam Donaldson thinks fourth: “(1) Business reform-the signature feature –and reducing the corporate rates. (2) Slowing down the pace of tax audits. (3) Special provisions for individuals with net operating losses in excess of \$900 million. (4) Somewhere below that is estate tax repeal.” — Sam Donaldson
- bb. **GRAT Animals.** “We have heard anecdotally of increased GRAT audits. GRATs have strict requirements. They are powerful animals, but if you don’t care for and feed them properly, they can bite you.” – Todd Angkatavanich
- cc. **Creditor Protection in Texas.** “Texas was founded by debtors running away from creditors in the East, so it is a good place for debtors to live.” —Stacy Eastland
- dd. **Stretch Out IRAs.** “The kids want to know whether they can withdraw funds from the IRA on the way to the funeral or if they have to wait until after the funeral.” — Mickey Davis
- ee. **The Divorce Lawyer’s View of Estate Planning.** “Take off your trust and estate hat when you venture into this divorce area. It is a different world. They think differently. The rules are different.” Scott Rubin (family lawyer in Miami, Florida) adds that “in the family lawyer’s world, a living trust is always revocable.”
- ff. **Engagement Letters.** Engagement letters should include “we don’t guarantee results.” —Bruce Stone
- gg. **Just Agree There Are No Taxes.** “Late in the evening at the end of protracted settlement discussions of fiduciary disputes, litigators will often say ‘Let’s just agree the tax will be ...’ or ‘let’s just agree there are no tax issues.’ —Melissa Willms
- hh. **Godzilla IRS.** In reviewing the executor’s personal liability under the literal terms of 31 USC 3713, “it looks like the IRS is Godzilla, the estate is Tokyo, and too bad – everything is doomed.” – Melissa Willms
- ii. **Client Screening.** “A lawyer should be measured not by the quality of clients he has, but by the clients he has turned away.” – Shawn Snyder (quoting her mentor as a young lawyer)
- jj. **Live It Up.** In discussing when to begin receiving Social Security, Larry Frolik observes that cash flow at 66 may be more “valuable” than having additional cash at age 85, if travel or other experiences may no longer be possible at age 85 (i.e., if you can no longer go scuba diving). (“I frankly don’t care if I’m the richest guy in the nursing home.”) – Larry Frolik
- kk. **Three-Year Rule for Sale by Charitable Donee.** Charities must file Form 8282 with the IRS if they dispose of illiquid gifts within three years of the donation. Turney Barry tells charitable clients not to dispose of assets within that three-year period. “You might think, cynically, my reason is that if you told the IRS they would view it as nefarious. No, I’m a taxpayer as you are, and I don’t want to burden the government with unnecessary paperwork.” – Turney Barry

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- II. **Three Years.** “Three years is a long time. Smart people can go through college in three years. Not any of us, but smart people can go to college in three years.”  
– Turney Berry
- mm. **Charitable Receipt Horror Story.** In December, 2016, headlines were in the newspapers about a corporation that was denied a \$64 million charitable deduction because it did not get a proper receipt from the charity. It did receive a receipt, but the receipt did not have the “no goods or services were provided” language. The entire \$64 million charitable deduction was lost. The case is *15 West 17<sup>th</sup> Street LLC v. Commissioner*, 147 T.C. No. 19 (Dec. 22, 2016). – Susan Abbott
- nn. **Section 501(c)(4) Changed Gift Rule.** The 2015 PATH Act provided that gifts to §501(c)(4) organizations would not be taxable gifts (even though no income tax charitable deduction is allowed). The IRS had issued rulings in the 70s saying that contributions to those organizations were taxable gifts. “In effect, the IRS was saying ‘no moron gives political contributions unless they expect something in return. What kind of country do you think we’re dealing with?’” – Turney Berry
- oo. **Think Ahead.** Asset protection is part of mainstream estate planning. “Regardless of what someone’s estate protection plan involves, the planning should be placed on today’s agenda – not tomorrow’s agenda.” – Gideon Rothschild
- pp. **It’s What You Don’t Know.** “There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don’t know. But there are also unknown unknowns. There are things we don’t know we don’t know.” – Donald Rumsfeld (quoted by Stacy Singer)
- qq. **A Tax Reform Certainty.** Howard Zaritsky discussed the hurdles of estate tax repeal, including budget issues, but concluded that there is a “100% chance of some kind of change.” – Howard Zaritsky
- rr. **Meet With Client Every Three Years.** Things change in client’s lives, and Stuart Baer recommends meeting with clients every 3 to 5 years to determine whether changes to the estate plan are appropriate. He sends a note to clients after three years saying “Come see me. It’s a free meeting. I’ll serve coffee.” By the time they procrastinate, we’re at the five year mark. – Stuart Bear
- ss. **Testamentary Capacity Reflections.** “The standard for testament capacity is lower than the capacity standard for other transactions. To paraphrase George Carlin (and clean it up), the testamentary capacity standard is simply: ‘I know my stuff and I understand who is to receive my stuff.’ Why is the capacity standard lower for wills than for other documents? The lower standard is for a transfer that occurs after death, and it doesn’t affect the person personally and their lifestyle. A power of attorney or health care directive affects the client during life.” – Stuart Bear