“CHANGES” - RECENT DEVELOPMENTS IN FEDERAL CASE LAW, REGULATIONS, AND DELAWARE TRUST LAW

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RECENT DEVELOPMENTS

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RECENT DEVELOPMENTS*

LEGISLATIVE PROPOSALS AND IRS GUIDANCE

1. The Administration's Estate Tax Budget Proposals for Fiscal Year 2017 and Related Items (February 9, 2016)

Obama Administration's Budget Proposal for fiscal year 2017 could affect estate planning

On February 9, 2016, the Administration released its "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals," which is often referred to as the "Greenbook," to accompany its proposed Fiscal Year 2017 Budget. The 2016 Greenbook seeks to expand the requirement of consistency in value for transfer and income tax purposes that became law on July 31, 2015 with the enactment of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015. It also continues estate, gift, and generation-skipping tax proposals from past Greenbooks.

New Proposal: Expand Requirement of Consistency in Value for Transfer and Income Tax Purposes.

The Administration proposes to expand the property subject to the consistency requirements imposed under Section 1014(f) to also include property qualifying for the estate tax marital deduction if a return is required to be filed for federal estate tax purposes (even though the property does not increase the estate tax liability of the estate) and property transferred by gift, provided that the gift is required to be reported on a federal gift tax return.

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (the Act), requires that a recipient's basis in property received from a decedent be the same as the value reported for estate tax purposes. The Act amended Section 1014 to provide generally that the recipient's initial basis in property as determined under Section 1014 cannot exceed the final value of that property for estate tax purposes. This Administration proposes to expand the application of Section 1014 beyond applying only to items of property that generate a federal estate tax. In particular, the Administration wishes to apply the consistency requirement to property qualifying for the estate tax marital deduction. The Administration admits in the Greenbook that while the value of property passing to a decedent's surviving spouse may be increased without incurring any federal estate tax, there are provisions in the Internal Revenue Code to prevent an inaccurately high estate tax valuation.

*This outline is based on materials prepared by McGuireWoods LLP lawyers Ronald D. Aucutt, Dennis I. Belcher, W. Birch Douglass III, Andrea C. Chomakos, Charles D. Fox IV, and Stephen W. Murphy.

Continuation of Proposals from Prior Greenbooks

Increasing the Capital Gains Tax Rate and "Closing the Trust Fund Loophole." As was discussed in the President's 2015 State of the Union Address, the Administration proposes to increase the highest long-term capital gains and qualified dividend tax rate from 20 percent to 24.2 percent. The 3.8 percent net investment income tax would continue to apply as under current law. The maximum total capital gains and dividend tax rate including net investment income tax would consequently rise to 28 percent.

The Administration describes the proposal on treating transfers as realization events as follows:

> Under the proposal, transfers of appreciated property generally would be treated as a sale of the property. The donor or deceased owner of an appreciated asset would realize a capital gain at the time the asset is given or bequeathed to another. The amount of the gain realized would be the excess of the asset's fair market value on the date of the transfer over the donor's basis in that asset. That gain would be taxable income to the donor in the year the transfer was made, and to the decedent either on the final individual return or on a separate capital gains return. The unlimited use of capital losses and carry-forwards would be allowed against ordinary income on the decedent's final income tax return, and the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any). Gifts or bequests to a spouse or to charity would not be subject to the tax. Instead, gifts or bequests to a spouse or to charity would carryover the basis of the donor or decedent. Capital gain would not be realized until the spouse disposes of the asset or dies, and appreciated property donated or bequeathed to charity would be exempt from capital gains tax.
>
> The proposal would exempt any gain on all tangible personal property such as household furnishings and personal effects (excluding collectibles). The proposal also would allow a $100,000 per-person exclusion of other capital gains recognized by reason of death that would be indexed for inflation after 2017, and would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes (making the exclusion effectively $200,000 per couple). The $250,000 per person exclusion under current law for capital gain on a principal residence would apply to all residences, and would also be portable to the decedent's surviving spouse (making the exclusion effectively $500,000 per couple).
>
> The exclusion under current law for capital gain on certain small business stock would also apply. In addition, payment of tax on the appreciation of certain small family-owned and family operated businesses would not be due until the business is sold or ceases to be family-owned and operated. The proposal would further allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made.

This proposal would be effective for gifts made and decedents dying on or after January 1, 2017. Most commentators believe that this proposal is as dead on arrival in 2016 as it was when it was first proposed in 2015.

Revisitation of Estate Tax Rates and Exemptions. The Greenbooks for the last seven years, all the years of the Obama Administration, have proposed permanently setting the estate, gift, and GST taxes at 2009 levels, in which the top rate was 45 percent and the exemptions (technically "exclusion amounts") were $3.5 million for the estate and GST taxes and $1 million for the gift tax, not indexed for inflation. Even though the rate and exemption for these taxes were permanently set in January 2013 at 40 percent and $5 million indexed since 2011, the current Greenbook renews the call to return to 2009 levels, beginning in 2017. It also calls for the "portability" of the exclusion amount between spouses to be permanently retained. By 2017 there will be a new President and there will have been one more congressional election, and it is hard to guess why 2017 is used. But it certainly does not appear to call for any immediate estate planning action.

Modification of the Gift Tax Annual Exclusion. The 2016 Greenbook continues the proposal first made in the 2014 Greenbook to modify the gift tax annual exclusion. The 2016 Greenbook cites Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968), and points out that the use of "Crummey powers" has resulted in significant compliance costs, including the costs of giving notices, keeping records, and making retroactive changes to the donor's gift tax profile if an annual exclusion is disallowed. The Greenbook adds that the cost to the IRS of enforcing the rules is significant too.

The Greenbook also acknowledges an IRS concern with the proliferation of Crummey powers, especially in the hands of persons not likely to ever receive a distribution from the trust, and laments the IRS's lack of success in combating such proliferation (citing Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991); Kohlsaat v. Commissioner, T.C. Memo 1997-212).

The Greenbook offers the following explanation of the proposal:

> The proposal would eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion. Instead, the proposal would define a new category of transfers (without regard to the existence of any withdrawal or put rights), and would impose an annual limit of $50,000 per donor on the donor's transfers of property within this new category that will qualify for the gift tax annual exclusion. Thus, a donor's transfers in the new category in a single year in excess of a total amount of $50,000 would be taxable, even if the total gifts to each individual donee did not exceed $14,000. The new category would include transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

As to interests in passthrough entities, see the IRS successes in Hackl v. Commissioner, 118 T.C. 279 (2002), aff'd, 335 F.3d 664 (7th Cir. 2003) (interests in an LLC engaged in tree farming); Price v. Commissioner, T.C. Memo 2010-2 (interests in a limited partnership holding marketable

stock and commercial real estate); Fisher v. United States, 105 AFTR 2d 2010-1347 (D. Ind. 2010) (interests in an LLC owning undeveloped land on Lake Michigan).

The proposal would be effective for gifts made after the year of enactment. It is estimated to raise revenues by $2.924 billion over 10 years.

This is what apparently would be left as excludable gifts:

> Unlimited gifts directly for tuition or medical expenses under section 2503(e).
>
> Gifts up to $14,000 (currently) per donee per year, or $28,000 if split, consisting of:
>
> > outright gifts and
> >
> > gifts to trusts described in section 2642(c)(2)—that is, "tax-vested" trusts exempt from GST tax. This latter provision would effectively permit "2503(c) trusts" to any age (not just 21).
>
> Up to $50,000 annually of "mad money" for anything that is otherwise impermissible or at least suspect. There would not have to be an arguable basis for the annual exclusion under current law. (The Greenbook provides the simple example of "transfers in trust.")

Expand Applicability of the Definition of Executor. The 2016 Greenbook also contains the proposal first made in the 2014 Greenbook to expand the definition of "executor" in Section 2203. The Internal Revenue Code currently defines executor as the executor or administrator of the decedent's estate, or, if none, then "any person in actual or constructive possession of any property of the decedent." This could include the trustee of a decedent's revocable trust, an IRA or life insurance beneficiary, or a surviving joint tenant of jointly owned property. The current definition does not give the executor the ability to act on behalf of a decedent with regard to a tax liability that arose prior to a decedent's death. Some actions that an executor currently cannot by law take include extending the statute of limitations, claiming a refund, agreeing to a compromise or assessment, or pursuing judicial relief. Problems also arise if there is no appointed executor and multiple persons meet the definition of "executor."

The proposal would make the Internal Revenue Code's definition of executor applicable for all tax purposes including acting on behalf of the decedent with respect to pre-death tax liabilities or obligations. The proposal would also grant regulatory authority to adopt rules to resolve conflicts among multiple executors.

Grantor Trusts. A "grantor trust" is treated as "owned" by the grantor (creator) of the trust during the grantor's lifetime or some shorter period. As a result, after the grantor makes a gift to an irrevocable grantor trust, with the grantor's descendants, for example, as beneficiaries, the income tax on that trust's income must be paid by the grantor, even though the income belongs to the trust and its beneficiaries. That permits the grantor to make income tax payments that benefit the trust and its beneficiaries without treating those payments as additional gifts.

Grantor trust treatment also permits transactions between the trust and the grantor without income tax, including sales without capital gain and payment of interest without creating taxable income. That feature has supported the popular and effective estate planning technique of an installment sale to a grantor trust, in which assets are sold to the trust for a promissory note with lenient terms (especially at today's low interest rates), often with a small "down payment." The future appreciation in the value of those assets in excess of the modest interest rate escapes gift and estate tax. The trust can also last for multiple generations and be made exempt from the generation-skipping transfer (GST) tax by allocation of the grantor's GST exemption. That feature of grantor trusts also permits fine-tuning or updating the assets of the trust by the grantor's exchange of assets with the trust, again without capital gain or gift treatment.

In the 2012 Greenbook, for the first time, the Administration proposed changes to the estate and gift taxation of grantor trusts treated as owned by the grantor for income tax purposes. As written, those proposals appeared designed to treat all such grantor trusts as fully subject to estate tax when the grantor dies or to gift tax if grantor trust status ceases during the grantor's life. Observers did not believe that such a sweeping change was intended, and we waited for clarification in this year's version of the proposal.

This 2016 Greenbook (as did the 2013, 2014 and 2015 Greenbooks) narrows the proposal. It will not apply to all grantor trusts. It will subject to estate tax (or gift tax) only "the portion of the trust attributable to the property received by the trust" from the grantor in an installment sale or similar transaction. The reference to "the portion of the trust" includes the growth in the value of that property, income earned from that property, and the reinvestment of the proceeds of any sales of that property. The amount subject to gift or estate tax will be reduced by the consideration paid by the trust in the sale, presumably including the face amount of the promissory note in most cases. But, of course, the amount of that consideration is typically a fixed amount, while the assets that are sold are usually expected to increase in value.

If enacted as proposed, this change would apply to sales after the date the President signs the law and would effectively eliminate all typical estate tax benefits of such sales and end the use of such sales in the manner to which we have become accustomed. All future appreciation in the assets that are sold would be subject to estate tax no matter how long the grantor lives and whether or not the note is paid off. Attempts to avoid that by terminating grantor trust status during the grantor's life or making distributions from the trust would be subject to gift tax. Because that portion of the trust would be subject to estate tax, the grantor would be unable to allocate GST exemption to it.

If legislation along these lines is enacted, we believe that there would still be some estate tax value in installment sales to irrevocable trusts that are not grantor trusts. But those advantages would be significantly reduced, and many donors would prefer the more predictable benefits of a grantor retained annuity trust (GRAT). Some efforts might be made to design workarounds, possibly including expanded use of the technique of turning grantor trust status on or off, but those techniques would likely attract close scrutiny by the Internal Revenue Service.

There is some comfort, however, in the Greenbook proposal that the legislation authorize Treasury to create exceptions from the proposed estate tax treatment. Those exceptions could include helpful "safe harbors" that relax the rules in the case of sales that meet certain standards.

But it is most unlikely that we will know those exceptions and standards before the legislation is enacted. And it is hard to tell what the legislative prospects are. Estimated to raise revenue of slightly over a billion dollars over ten years, the proposal will not be irresistible as a weapon against deficits, but its appeal in an every-little-bit-helps environment is impossible to predict.

Meanwhile, then, anyone considering an installment sale to a grantor trust should consider completing it, not as a rush project but without avoidable long delay or inattention, which is usually good advice for any estate planning actions like this. Some of those installment sales might be made to trusts that were created and funded in the surge of gift-giving in 2012 when the future of the gift tax exemption was uncertain.

Minimum Ten-Year Term for GRATs and Other Changes. A grantor retained annuity trust is economically similar to an installment sale to a grantor trust, in that it protects from estate tax the appreciation in excess of the interest rate used to calculate the amount of the gift when property is transferred to the GRAT and the grantor retains a stream of annual payments for a stated term. Sometimes GRATs are seen as even preferable to installment sales, because GRATs follow a clear and predictable pattern set forth in tax regulations. One disadvantage of a GRAT is that it will be subject to estate tax, but only if the grantor dies during the stated term. For that reason, many GRATs have had relatively short terms, such as two years.

This year's proposal continues the identical proposal made in the 2015 Greenbook. As in the Greenbooks since 2012, the 2016 Greenbook would require a GRAT to have a minimum term of ten years. The 2016 Greenbook also contains the proposal first made last year in the 2015 Greenbook to eliminate the common practice of "zeroing-out" by designing the annuity to produce a very low gift tax value by requiring the remainder interest to have a minimum value of the greater of 25 percent of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed). It would also prohibit decreases in the annuity during the term and prohibit the grantor from engaging in any tax-free exchange of assets in the trust. Finally, the proposal would prohibit the GRAT from having a term that extended more than ten years beyond the life expectance of the grantor at the time the GRAT was created.

As with this proposal in the past, it is hard to estimate its prospects, although a similar proposal was approved by the House of Representatives in three rather partisan votes in 2010 under Democratic control, and this proposal is estimated to raise almost $3.9 billion over ten years. As with the proposal regarding installment sales, the lesson is that GRATs under consideration should probably be completed if it is reasonable to do so, again not necessarily in a rush but with reasonable dispatch.

Change in GST Tax Rules for "Health and Education Exclusion Trusts" ("HEETs"). A health and education exclusion trust (or "HEET") is a complex and uncertain technique. It builds on the statutory rule that distributions from a trust that is not exempt from GST tax directly for a beneficiary's school tuition or medical care or insurance are not generation-skipping transfers, no matter what generation the beneficiary is in. By including charities as permissible beneficiaries with somewhat vague interests, the designers of such trusts hope to avoid a GST tax on the "taxable termination" that would otherwise occur as interests in trusts pass from one generation to another.

The 2016 Greenbook repeats the proposal that was new in the 2013 and 2014 Greenbooks and that would limit the exemption of direct payments of tuition and medical expenses from GST tax to such payments made by individuals, not distributions from trusts. In contrast with other proposals, the Greenbook proposes that this change would be effective when the bill proposing it is introduced and would apply both to trusts created after that date and to transfers after that date to pre-existing trusts.

Because of the lack of authority or consensus for their design, the use of HEETs is likely not as widespread as the use of installment sales or GRATs. But because of the abrupt effective date provision that is proposed, any contemplated HEETs should be completed promptly.

Also, because the proposal appears intended to repeal an exception for all generation-skipping trusts, not just trusts designed as HEETs, it might be thought that the creation and funding of all such trusts should be placed on a rush basis. Many of us do not recommend that because we expect that the reach of this proposal will be recognized as overbroad, and, if it is enacted, it will be in a more limited form. Even if it might be enacted as proposed, we believe that the care needed in designing all the features of a long-term trust, not just provisions for tuition or medical expenses, ordinarily should not be compromised.

Other Technical Estate Tax Changes. The Greenbook carries forward the proposal made in past years to provide an extension of liens when payment of the estate tax on closely held business interests is deferred.

Income Tax Proposals. There are again income tax proposals in the 2016 Greenbook that could significantly affect individual taxpayers. For example, so-called "stretch IRAs" inherited by beneficiaries other than the original owner's spouse would be limited to a term of five years. A controversial proposal would limit the total amount that could be accumulated in a tax-free retirement arrangement to an amount calculated with reference to the maximum annual benefit from defined benefit plans, currently about $3.4 million at age 62. Original owners of Roth IRAs would be required to take distributions from Roth IRAs after attaining age 70 ½ in the same way as owners of traditional IRAs. For individuals in the 33, 35, and 39.6 percent income tax brackets, the effect of certain exclusions and deductions would be limited to the effect they would have had in the 28 percent bracket. And the "Buffett Rule" would be implemented by a new minimum tax, called a "Fair Share Tax," ensuring a tax of at least 30 percent of adjusted gross income less a 28 percent credit for charitable contributions.

Unlike the technical estate tax proposals, these proposals are likely to move forward, if at all, in the context of a broad and intense debate about tax reform, the distribution of tax burdens, and the appropriate "balance" between spending and taxation.

2. 2016–2017 Priority Guidance Plan (August 15, 2016)

Treasury Department and the Internal Revenue Service release their 2016–17 priority guidance plan

The annual priority guidance plan contains the following 12 items under the heading of "Gifts and Estates and Trusts" for the years 2016 to 2017:

1. Guidance on qualified contingencies of charitable remainder annuity trusts under Section 664.

2. Guidance on definition of income for spousal support trusts under Section 682. [NEW]

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

4. Final regulation under Sections 1014(f) and 6035 regarding consistent basis reporting between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016.[NEW]

5. Revenue procedure under Section 2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability.

6. Guidance on the valuation of promissory notes for transfer tax purposes under Sections 2031, 2033, 2512, and 7872.

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

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

9. Guidance on the gift tax effect of defined value formula clauses under Sections 2512 and 2511.

10. Guidance under Sections 2522 and 2055 regarding the tax impact of certain irregularities in the administration of split-interest charitable trusts.[NEW]

11. Regulations under Section 2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships. Proposed regulations were issued on August 2, 2016.

12. Guidance under Section 2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates.

The items deleted from the 2015-16 Priority Guidance Plan are:

1. Final regulations under Section 1014 regarding uniform basis of charitable remainder trusts. Proposed regulations were published on January 17, 2014. Final regulations were issued on August 11, 2015.

2. Regulations under Section 2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP.

3. Final regulations under Section 2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008.

3. **Revenue Procedure 2015-53, 2015-47 IRB 1 (October 21, 2015)**

IRS provides the 2016 inflation adjusted amounts for tax exemptions, deductions, brackets, and other items

This Revenue Procedure provides the 2016 inflation adjusted item amounts for tax exemptions, deductions, brackets and other tax items. Selected adjusted income and gift and estate tax numbers are:

- The gift tax annual exclusion remains at $14,000.
- The estate tax applicable exclusion amount is increased because of the inflation adjustment to $5,450,000.
- For an estate of a decedent dying in 2015, the aggregate decrease in the value of qualified property for which a special use valuation election is made under Section 2032 cannot exceed $1,110,000.
- The annual exclusion for gifts to non-citizen spouses is increased to $148,000.
- Recipients of gifts from certain foreign persons must report these gifts if the aggregate value of the gifts received in 2015 exceeds $15,671.
- For estates making the Section 6166 election to defer estate tax on closely held businesses and pay the tax in installments, the dollar amount used to determine the "2 percent portion"(for purposes of calculating the interest owed) is $1,480,000.
- The top 39.6% income tax rate hits at the following amounts for the different categories of taxpayers:

Married Individuals Filing Jointly	$466,950
Heads of Households	$441,000
Unmarried Individuals	$415,050
Married Individuals Filing Separately	$233,475
Estate and Trusts	$12,400

- The "Kiddie Tax" exemption increases to $1,050.

4. **Surface Transportation and Veterans Health Care Choice Improvement Act (Public Law 114-41) (July 31, 2015); Notice 2015-57, 2015-36 I.R.B. 294 (August 21, 2015); Notice 2016-19, 2016-9 I.R.B. (February 9, 2016); Notice 2016-27, 2016-15 I.R.B. 576 (March 24, 2016)**

Enactment of consistency in basis legislation and subsequent developments

On July 31, 2015, the day that funding for the Highway Trust Fund was scheduled to expire, President Obama signed into law the Surface Transportation and Veterans Health Care Choice

Improvement Act (Public Law 114-41), extending that infrastructure funding for three months, with the $8 billion cost funded by various tax compliance measures. One of those compliance measures is section 2004 of the Act, labelled "Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent," which added new Sections 1014(f) and 6035 to the Code.

Section 1014(f) requires in general that the basis of property received from a decedent may not exceed the value as finally determined for estate tax purposes, or, if there is no final determination (as in the case of property sold while an estate tax audit is still in progress or, within the statutory period for assessments, has not begun), the value reported on the estate tax return.

Section 6035 imposes reporting requirements on every executor (or person in possession of property with the statutory duties of an executor) who is required to file an estate tax return – that is, in general, if the gross estate plus adjusted taxable gifts exceeds the applicable filing threshold, but also, apparently, under Reg. §20.2010-2(a)(1), if a return is filed only to elect portability. Such a person is required to furnish to the IRS and to the recipients of property interests included in the decedent's gross estate a statement setting forth the value of those property interests reported on the estate tax return. This statement is due 30 days after the due date (including extensions) of the estate tax return. Every such statement must be supplemented if a value is adjusted, for example, on audit.

Penalties apply for failure to file a required statement and for reporting basis inconsistently with such a statement.

This legislation resembles legislative proposals in the Treasury Department's annual "General Explanations" of revenue proposals associated with the Obama Administration's budget proposals ("Greenbooks"), including a proposal on pages 195-96 of the 2015 Greenbook. Unlike the Greenbook proposals, however, what Congress enacted applies only to property acquired from a decedent, not to gifts, and, under Section 1014(f)(2), applies "only … to any property whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11 (reduced by credits allowable against such tax) on such estate." In other words, the new consistency rule apparently does not apply in general to property specifically bequeathed to a surviving spouse or to charity, or to property that does not pass to the surviving spouse but is reported on an estate tax return filed only to elect portability. Thus, the consistency rule would not apply at all to the assets of an estate that is not subject to estate tax, but it would generally apply to every asset (not specifically bequeathed to the surviving spouse or charity) of an estate that is taxable because every such asset "increase[s] the liability for … tax" even if by merely absorbing some of the available exclusion amount. (Oddly, there is no corresponding exception to the reporting requirement of Section 6035.)

Notice 2015-36

In addition, while the Greenbook proposals would have been effective for transfers – that is, for decedents dying – on or after the date of enactment, section 1014(f) as enacted is applicable to property with respect to which an estate tax return is filed after the date of enactment. This produces a significant acceleration of the application of the statute. A return filed after the date

of enactment might have been due, and filed, on August 1, 2015, making the first statements under these rules due on August 31, 2015.

Apparently in recognition of that accelerated application, Notice 2015-57, 2015-36 I.R.B. 294, released on August 21, 2015, extended to February 29, 2016, the due date of any statements required by section 6035 that otherwise would be due before that date. The Notice cites Section 6081(a), which allows extensions of time only for up to six months except in the case of taxpayers who are abroad. February 29, 2016, is the closest date the calendar allows to six months after August 31, 2015. So the Notice signals that this will be the only extension.

Notice 2015-57 also states that "[t]he Treasury Department and the IRS expect to issue additional guidance to assist taxpayers with complying with Sections 1014(f) and 6035." We should expect this guidance by February 29, 2016; it affects too many estates to be deferred beyond that date. Among the guidance that might be appropriate, certain regulations are explicitly contemplated and authorized or even directed by the statute. Section 1014(f)(4) states that "[t]he Secretary may by regulations provide exceptions to the application of this subsection." And section 6035(b) states that "[t]he Secretary shall prescribe such regulations as necessary to carry out this section, including regulations relating to (1) the application of this section to property with regard to which no estate tax return is required to be filed, and (2) situations in which the surviving joint tenant or other recipient may have better information than the executor regarding the basis or fair market value of the property." Guidance on other subjects will likely also be considered.

Form 8971

A draft Form 8971 for reporting the necessary information was released on December 18, 2015. It contains space for listing five beneficiaries and includes a Schedule A (to be given to each beneficiary, like a K-1) with space for listing six assets. Clearly the liberal use of continuation sheets is contemplated.

A preliminary draft of Instructions has appeared on the Office of Management and Budget website. Regarding the dilemma of how to even know 30 days after filing the estate tax return which beneficiaries will receive which property, the draft states:

All property acquired (or expected to be acquired) by a beneficiary must be listed on that beneficiary's Schedule A. If the executor has not determined which beneficiary is to receive an item of property as of the due date of the Form 8971 and Schedule(s) A, 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 be filed once the distribution to each such beneficiary has been made.

On Schedule A of the draft Form 8971, for each asset, the executor is to answer the question "Did this asset increase estate tax liability?" and is to provide the valuation date and the estate tax value. Schedule A adds the following:

Notice To Beneficiaries:

> 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 of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional.

Notices 2016-19 and 2016-27

Notice 2016-19, 2016-9 I.R.B. (February 10, 2016) extended the furnishing or filing of the statements due to report the information required to be furnished to beneficiaries and the IRS under the consistency in basis legislation from February 29 to March 31. The date was subsequently extended to June 30, 2016 by Notice 2016-27, 2016-15 I.R.B. 576 (March 24, 2016).

5. IRS Frequently Asked Questions on Estate Tax (June 18, 2015)

IRS announces that taxpayers must now request closing letters for federal estate tax returns filed on or after June 1, 2015

In a change to its "Frequently Asked Questions on the Estate Tax," the IRS has announced that for all federal estate tax returns filed on or after June 1, 2015, estate tax closing letters will be issued only upon request by the taxpayer. The taxpayer must wait at least four months after filing the return to request the closing letter, to allow time for processing. If the taxpayer does not request a closing letter, the taxpayer will have wait the statutory three year period to learn if the estate tax return will be reviewed.

Catherine Hughes, a Treasury Department estate and gift tax attorney-adviser, stated on September 18 that the IRS will soon allow practitioners to ask for a transcript of an estate tax return, with a code that indicates that the IRS has completed its examination of the estate tax return. The IRS has suggested that this code number will be the equivalent of a closing letter from the IRS.

On December 4, 2015, the IRS announced that account transcripts, which reflect transactions including the acceptance of the Form 706 and the completion of an examination, may be an acceptable substitute for the estate tax closing letter. Account transactions are available online to registered tax professionals using the Transcript Delivery Service (TDS) or to authorized representatives making a request using a Form 4506-T.

MARITAL PLANNING

6. T.D. 9725, 2015-26 I.R.B. 1122 (June 12, 2015)

Final portability regulations are issued

Temporary regulations and identical proposed regulations with respect to portability were released on June 15, 2012. Final regulations were released on June 12, 2015, very close to the expiration date of the temporary regulations on June 15, 2015.

The final regulations provide that an extension of time to elect portability will not be granted under Treas. Reg. § 301.9100-3 in any estate that is required to file any estate tax return because the value of the gross estate equals or exceeds the applicable exclusion amount. However, an extension of time may be granted under the rules set forth in Treas. Reg. § 301.9100-3 to estates with a gross estate value below the applicable exclusion amount and thus not otherwise required to file an estate tax return. As a consequence, the final regulations did not extend the availability of the automatic extension of time for executors of certain estates under the applicable exclusion amount to file an estate tax return to elect portability with respect to decedents dying before January 1, 2015. This temporary extension of time was found in Revenue Procedure 2014-18, 2014-7 I.R.B. 513.

The Service also determined that only executors may elect portability. Some commentators had requested that the final regulations allow a surviving spouse who is not an executor to file an estate tax return and make the portability election in several different circumstances.

With respect to Qualified Domestic Trusts, the final regulations provide that if the surviving spouse becomes a citizen of the United States and is no longer subject to the requirements for a Qualified Domestic Trust, then the decedent's deceased spousal unused exclusion (DSUE) amount is no longer subject to adjustment and will become available to transfers by the surviving spouse as of the date the surviving spouse becomes an United States citizen.

The final regulations confirm that the DSUE amount of the last deceased spouse dying after 2010 is available both to the surviving spouse for gift tax purposes and to the surviving spouse's estate for estate tax purposes. Neither remarriage nor divorce will affect that availability. The death of a subsequent spouse will terminate the availability of the DSUE amount from the previous last deceased spouse. The final regulations also preserve the ordering rule providing that when the surviving spouse makes a taxable gift, the DSUE amount of the last deceased spouse (at that time) is applied to the surviving spouse's taxable gifts before the surviving spouse's own basic exclusion amount. The effect of these rules is to permit a surviving spouse, by making gifts, to benefit from the DSUE amounts of more than one predeceased spouse.

A related item on the current IRS Priority Guidance Plan is entitled "Revenue Procedure Under Section 2010(c)" regarding validity of a "QTIP election on an estate tax return filed only to elect portability." It is likely that the contemplated revenue procedure will eventually affirm the validity of a QTIP election made on an estate tax return not needed for estate tax purposes, but filed to make the portability election.

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

Extension of time to make portability election permitted

Each of the letter rulings listed below has the same fact pattern. Decedent's estate was less than the applicable exclusion amount in the year of decedent's death. Decedent's estate failed to file a federal estate tax return to make the portability election and discovered its failure to elect portability after the due date for making the election. In each letter ruling, the IRS determined that the requirements of Treas. Reg. § 301.9100-3 for granting an extension of time to make an election were met. Under this regulation, an extension of time will be granted if a taxpayer is deemed to have acted reasonably and in good faith. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer if the tax professional failed to make or advise the taxpayer to make the election.

The letter rulings are:

1. Letter Ruling 201604013 (Issued October 14, 2015; released January 22, 2016)
2. Letter Ruling 201604014 (Issued September 2, 2015; released January 22, 2016)
3. Letter Ruling 201605009 (Issued September 21, 2015; released January 29, 2016)
4. Letter Ruling 201605010 (Issued September 30, 2015; released January 29, 2016)
5. Letter Ruling 201605011 (Issued October 2, 2015; released January 29, 2016)
6. Letter Ruling 201608008 (Issued November 6, 2015; released February 19, 2016)
7. Letter Ruling 201608010 (Issued November 5, 2015; released February 19, 2016)
8. Letter Ruling, 201625002 (Issued March 8, 2016; released June 17, 2016)
9. Letter Ruling, 201626001 (Issued March 15, 2016; released June 24, 2016)
10. Letter Ruling, 201626014 (Issued March 17, 2016; released June 24, 2016)
11. Letter Ruling, 201626015 (Issued March 14, 2016; released June 24, 2016)
12. Letter Ruling, 201626021 (Issued March 10, 2016; released June 24, 2016)

13. Letter Ruling, 201626022 (Issued March 15, 2016; released June 24, 2016)
14. Letter Ruling, 201630001 (Issued March 29, 2016; released July 22, 2016)
15. Letter Ruling, 201630007 (Issued March 29, 2016; released July 22, 2016)
16. Letter Ruling, 201630010 (Issued March 23, 2016; released July 22, 2016)
17. Letter Ruling, 201630012 (Issued March 29, 2016; released July 22, 2016)
18. Letter Ruling, 201633002 (Issued April 28, 2016; released August 12, 2016)
19. Letter Ruling, 201633008 (Issued May 2, 2016; released August 12, 2016)
20. Letter Ruling, 201633023 (Issued April 20, 2016; released August 12, 2016)
21. Letter Ruling, 201633026 (Issued May 4, 2016; released August 12, 2016)

8. Letter Ruling 201605012 (Issued September 16, 2015; released January 29, 2016)

Extension of time permitted to 2010 decedent's estate to opt out of the estate tax

Decedent died in 2010. The executor retained an accountant to advise the estate on estate tax matters and to prepare the necessary tax filings for the estate. The accountant failed to advise the executor that the executor had to file the Form 8939 to opt out of the estate tax and elect carryover basis by January 17, 2012. Accountant prepared and filed the Form 8939 late. The executor requested an extension of time pursuant to Treas. Reg. § 301.9100-3 to file the Form 8939 to make the carryover basis election for the 2010 decedent.

The IRS found that the requirements of Treas. Reg. § 301.9100-3 had been satisfied. Under this regulation, relief will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that granting the relief requested will not prejudice the interest of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, and the tax professional failed to make or advise the taxpayer to make the election.

9. Letter Ruling 201603004 (Issued August 11, 2015; released January 15, 2016)

QTIP election is disregarded because the election was unnecessary to reduce estate tax liability to zero

At decedent's death, decedent established an A/B plan for the benefit of the surviving spouse. The amount that could be sheltered by decedent's applicable exclusion amount was to go into a credit shelter trust for the benefit of surviving spouse. The balance was to pass to surviving spouse outright.

Under the terms of the credit shelter trust, the spouse received all of the income from the trust and discretionary distributions of principal. The spouse was the only beneficiary of the credit shelter trust. The spouse had a five by five power of withdrawal over the trust and a special power to appoint the remainder interest to the children. The spouse, as executor of the decedent's estate, filed a federal estate tax return. All of the assets of the trust were included on Schedule M. By listing the assets of the trust on Schedule M of decedent's federal estate tax return, a QTIP election was made with respect to those assets. This, in turn, would cause the assets in the credit shelter trust to be subject to federal estate tax. Normally, a credit shelter trust is used to avoid the taxation of the assets in that trust at the deaths of both the first spouse and the surviving spouse.

In this situation, the QTIP election to treat the assets of the trust as qualifying for the marital deduction was unnecessary to reduce to the estate tax to zero because no estate tax would have been imposed on the assets in the trust whether or not the election was made. Revenue Procedure 2001-38, 2001-1 C.B. 1335, provides that a QTIP election will be treated as null and void where the election is not necessary to reduce the estate tax to zero. Because the QTIP election in this factual situation was unnecessary to reduce the estate tax liability to zero, the IRS stated that it would disregard the QTIP election with respect to the credit shelter trust and treat the QTIP election as null and void. As a result, the property in the trust would not be included in the surviving spouse's gross estate at the surviving spouse's death.

10. Letter Ruling 201615004 (Issued January 11, 2016; Released April 8, 2016)

Service rules on estate and gift tax consequences of settlement with respect to a marital trust

Decedent died with his property divided into a marital share and a Trust B(to be funded with the decedent's remaining applicable exclusion amount) under a fractional formula for an A/B plan at the death of the first spouse. The marital share was to be divided into two trusts, Trust C-1 and Trust C. Trust C-1 was intended to be exempt from generation skipping tax and Trust C was not.

Decedent was survived by his spouse and two children from a prior marriage. Decedent's executor listed Trust C and Trust C-1 on the Form 706 and the estate was deemed to have made the QTIP election with respect to both trusts even though Trust C gave the surviving spouse a testamentary general power of appointment.

State law provides that a noncharitable irrevocable trust may be terminated upon consent of all the beneficiaries if the court concludes that the continuance of the trust is unnecessary to achieve any material purpose of the trust. A noncharitable irrevocable trust may be modified on consent of all the beneficiaries if the court concludes that the modification is not inconsistent with a material purpose of the trust.

The trustee, spouse, and decedent's children entered into a settlement agreement to terminate Trust C and Trust C-1. Upon termination, the spouse would receive the liquid assets of the trusts. In exchange, the trustee would pay a percentage of spouse's income tax liability with respect to the distribution and any gift taxes payable under Section 2519. After that distribution, spouse

would be treated as deceased for all purposes. The remaining assets of Trust C and Trust C-1 would be distributed to Trust B. This letter ruling request was limited to the tax consequences to Trust C and spouse as a result of the termination of Trust C.

The first ruling requested was that since Trust C qualified for the marital deduction under Section 2056(b)(5), as a life estate/general power of appointment trust, the QTIP election made with respect to trustee was a nullity for QTIP purposes. The trust gave the spouse a testamentary general power of appointment to appoint to her estate and specifically referred to the general power of appointment conferred upon spouse. As a consequence, under Revenue Procedure 2001-38, 2001-1 C.B. 1335, which provides that a QTIP election will be treated as null and void where the election was not necessary to reduce the estate tax liability to zero, the Service held that the QTIP election made on decedent's federal estate tax return for Trust C was null and void. As a result, the property held in Trust C would not be includable in spouse's gross estate under Section 2044 as her death and spouse would not be treated as making a gift under Section 2519 if the spouse disposed of the income interest with respect to that property.

The Service next ruled that, upon the termination of spouse's interest in Trust C, the spouse released her general power of appointment under Section 2514. The release of the general power of appointment was deemed a taxable transfer by spouse of the value of the Trust C assets at the time of the release. A gift will be made to the extent that the release was for less and full and adequate consideration. This would be the amount by which the value of the property in Trust C exceeded the value of the consideration that the spouse received at the time of the settlement. Spouse would also be a transferor of the trust for GST purposes to the extent that she made a taxable gift.

GIFTS

11. **Estate of Davidson v. Commissioner, T.C. Docket No. 13748-3; Estate of Jack Williams v. Commissioner, (Tax Court Docket No. 29735-13, petition filed Dec. 19, 2013)**

Developments in sweeping IRS attack on time-honored techniques

A number of recent cases highlight particular issues in valuation of assets for purposes of the estate and gift tax. On July 6, 2015, the Internal Revenue Service settled Estate of Davidson v. Commissioner, T.C. Docket No. 13748-13. The IRS had alleged $2.8 billion in estate, gift and generation-skipping transfer taxes owed, and the IRS settled for approximately $320 million in additional estate and generation-skipping transfer tax, approximately $186 million in additional gift tax, and approximately $48 million in additional generation-skipping transfer taxes from lifetime transfers.

Davidson involved certain transactions by William M. Davidson, the former owner of the Detroit Pistons and the president, chairman, CEO and owner of 78 percent of the common stock of Guardian Industries Corp., one of the world's largest manufacturers of glass, automotive and building products. In December 2008 and January 2009, Davidson engaged in transactions including gifts, substitutions, a five-year grantor retained annuity trust (GRAT) and sales that eventually paid him no consideration at all. These transactions were similar to those challenged

by the IRS in Estate of Kite v. Commissioner, T.C. Memo 2013-43, in which no consideration was paid back to the grantor. At the time that Mr. Davidson made these transactions, he was 86, and the evidence suggested that his actuarial life expectancy was about five years. He lived for only 50 days after making the last transfer, and he died on March 13, 2009.

The consideration for some of Mr. Davidson's sales included five-year balloon unconditional notes at the applicable federal rate, five-year balloon self-canceling installment notes (SCINs) at the Section 7520 rate with an 88 percent principal premium, and five-year balloon SCINs at the Section 7520 rate with a 13.43 percent interest rate premium. Addressing Mr. Davidson's sales both in Chief Counsel Advice 201330033 (Feb. 24, 2012) and in its answer in the Tax Court, the IRS argued the notes should be valued, not under Section 7520, but under a willing buyer-willing seller standard that took account of Mr. Davidson's health. Even though four medical consultants, two chosen by the executors and two chosen by the IRS, all agreed on the basis of Mr. Davidson's medical records that he had had at least a 50 percent probability of living at least a year in January 2009, the IRS saw the notes as significantly overvalued because of his health, and the difference as a gift. Combined gift and estate tax deficiencies, with some acknowledged double counting, were about $2.8 billion.

The Davidson estate filed its Tax Court petition on June 14, 2013 (Docket No 13748-13), and the IRS filed its answer on August 9, 2013. Trial was set by the court for April 14, 2014, but the parties jointly moved to continue it. In an Order on December 4, 2013, that motion was granted, jurisdiction was retained by Judge David Gustafson, and the parties were ordered to file joint status reports on September 14, 2014 and every three months thereafter.

This settlement was entered by the court on July 6, 2015. In this settlement, the gift tax for prior years was increased by $186,626,788; the generation-skipping transfer tax for lifetime transfers was increased by $48,604,482; the total estate tax was increased from $139,411,144 as reported on the estate tax return to $291,902,040; and the generation-skipping transfer tax owed on the estate tax return was reduced by $450,000, from $29,071,193 to $28,621,193, for total estate and generation-skipping transfer tax liability of $320,523,233.

It remains to be seen whether this is a victory for the IRS, a victory for the taxpayer, or a draw.

In Estate of Jack Williams v. Commissioner (Tax Court Docket No. 29735-13, petition filed Dec. 19, 2013), the IRS challenged a partnership owning real estate and business and investment assets with a wide variety of arguments, including disregarding the existence of the partnership and treating transfers to the partnership as a testamentary transaction at the decedent's death; undervaluation of the partnership assets; lack of a valid business purpose or economic substance for the partnership; the decedent's retained enjoyment of the partnership assets; restrictions on the right to use or sell the partnership interest ignored under Section 2703(a); liquidation restrictions ignored under Sections 2703, 2704(a) and 2704(b); and any lapse of voting or liquidation rights in the partnership treated as a transfer under Section 2704(a). The IRS and the taxpayer recently settled the case.

12. **<u>Estate of Donald Woelbing v. Commissioner,</u> Tax Court Docket No. 30261-13, petition filed Dec. 26, 2013, <u>stipulated decision</u> entered March 25, 2016 and Estate of Marion <u>Woelbing v. Commissioner</u>, Tax Court Docket No. 30260-13, petition filed Dec. 26, 2013, <u>stipulated decision</u> entered March 28, 2016**

Parties settle related gift and estate tax valuation cases

The IRS and executors have settled two cases in the United States Tax Court involving members of the Woelbing family, who own Carma Laboratories, Inc., of Franklin, Wisconsin, the maker of Carmex skin care products, and a sale of Carma stock to an irrevocable trust in 2006 that relied on a "defined value clause." The agreed dispositions of the Tax Court cases indicate that the IRS conceded all the additional taxes and penalties it had previously asserted. But the end of this litigation still leaves questions and, perhaps, even warnings for estate planning clients and their advisors.

The cases are. In 2006 Mr. Woelbing sold his nonvoting Carma stock to an irrevocable grantor trust for an interest-bearing promissory note in the face amount of about $59 million. In other words, this was an installment sale to a grantor trust. After Mr. Woelbing died in 2009, the IRS challenged the 2006 sale in connection with its audit of his estate tax return and eventually asserted gift tax deficiencies with respect to both Mr. and Mrs. Woelbing and estate tax deficiencies with respect to Mr. Woelbing's estate. The taxes and associated penalties the IRS asserted totaled about $152 million.

In their Tax Court petition, Mr. Woelbing's executors described the sale as follows:

> In the 2006 stock sale transaction, Decedent sold all of his nonvoting stock of Carma Laboratories, Inc. to the Trust in exchange for an interest-bearing promissory note in the amount of $59,004,508.05. The purchase price was determined by an appraisal of the nonvoting stock's fair market value by an independent appraiser….
>
> The Installment Sale Agreement further provided that both the number of shares of stock sold and the purchase price of $59,004,508.05 were determined on February 28, 2006, but that Decedent and the Trust acknowledge that the exact number of shares of stock purchased by the Trust depends on the fair market value of each share of stock. The Installment Sale Agreement further provided that based on a recent appraisal of the stock, this results in 1,092,271.53 shares of stock being purchased but that in the event that the value of a share of stock is determined to be higher or lower than that set forth in the Appraisal, whether by the Internal Revenue Service or a court, then the $59,004,508.05 purchase price shall remain the same but the number of shares of stock purchased shall automatically adjust so that the fair market value of the stock purchased equals $59,004,508.05. [This type of provision is commonly known as a "defined value clause" or "value definition formula" or some variation.]

> At the time of the 2006 stock sale transaction and subsequently, the Trust had significant financial capability to repay the promissory note for the nonvoting stock of Carma Laboratories, Inc. without using the nonvoting stock of Carma Laboratories, Inc. or its proceeds. This substantial financial capability exceeded 10% of the face value of the promissory note. [Ten percent was the amount of the "down payment" or "equity" or "security" the IRS reportedly required as a condition of ruling favorably on an installment sale to a grantor trust in Letter Ruling 9535026 in 1995].
>
> At the time of the 2006 stock sale transaction, the Trust owned three life insurance policies on Decedent's and Mrs. Woelbing's lives with an aggregate cash surrender value of $12,635,722 [over 21% of $59 million]. All of this cash value could be pledged to a financial institution as collateral for a loan which could be used to make payments on the promissory note to Mr. Woelbing. Since Carma Laboratories, Inc. was required to continue making payments during Mr. and Mrs. Woelbing's lifetimes under the Split-Dollar Insurance Agreement, the amount of cash surrender value available for this purpose would continue to grow….
>
> At the time of the 2006 stock sale transaction, Petitioners, Paul Woelbing and Eric Woelbing [sons of Mr. and Mrs. Woelbing], beneficiaries of the Trust, executed personal guarantees in the amount of ten percent of the purchase price of the stock.

The IRS basically ignored the note, doubled the value of the stock on the date of the gift to $117 million, almost tripled the value of the stock as of the date of Mr. Woelbing's death to $162 million, and added that value of $162 million to his gross estate.

The IRS viewed the note as a form of "retained interest" in the trust, valued at zero under section 2702, which Congress enacted in 1990 as part of the "estate freeze" provisions of chapter 14 of the Internal Revenue Code. As a result, the IRS treated the entire value of the transferred shares, which it asserted to be $117 million, not $59 million, as a taxable gift in 2006, which increased the gift taxes owed by both Mr. and Mrs. Woelbing because they had elected to "split" gifts on their 2008 federal gift tax returns.

In addition, because the transferor, Mr. Woelbing, held that "retained interest" until his death and the IRS did not view his transfer of the stock as a bona fide sale for adequate and full consideration, the IRS asserted that the entire value of the stock on the date of his death, July 6, 2009, which it viewed as $162,191,400, was included in his gross estate under section 2036 of the Internal Revenue Code. For good measure, the IRS asserted that the enjoyment of the stock Mr. Woelbing transferred to the trust in 2006 was subject at the time of his death to his right to alter, amend, revoke, or terminate, within the meaning of section 2038 of the Code.

The decisions of the Tax Court, representing not the judgment of the Court but the outcome to which the executors and the IRS had stipulated, found no additional gift taxes due with respect to either Mr. or Mrs. Woelbing and no additional estate tax due with respect to Mr. Woelbing's estate. Estate taxes were not an issue with respect to the estate of Mrs. Woelbing, who died

September 29, 2013 (two days after the IRS issued its Notice of Deficiency, as her executors' petition pointed out). For that reason, the stipulated decisions have no impact on the estate tax liability of Mrs. Woelbing's estate, for which the statute of limitations has not run. It has been informally reported that an agreed upward valuation adjustment in the settlement was reflected in an agreed downward adjustment in the number of shares Mr. Woelbing transferred in the 2006 sale, much as the defined value clause contemplated. In that case, the value of those shares would have been included in his gross estate, would have qualified for a marital deduction, and thus presumably would increase the size of Mrs. Woelbing's gross estate and increase the amount of estate tax owed by her estate. The settlement with the IRS probably included her executors' agreement to make or accept those changes to her estate tax return.

But this is a surprising settlement, substantively and procedurally. It is especially surprising that the IRS would effectively agree to the defined value clause, which IRS personnel are known to really dislike. The only plausible explanation may be that the IRS attorneys thought their position on the valuation issue itself was very weak, and the executors' attorneys thought so too, and this was the only way the IRS was able to credibly seek any concession on value.

13. Letter Ruling 201614006, Letter Ruling 201614007, and Letter Ruling 201614008 (Issued December 4, 2015; Released April 1, 2016)

Contributions of property to incomplete non-grantor trusts are not completed gifts

This is another series of letter rulings dealing with a contribution to an incomplete non-grantor trust and the gift and income tax consequences of such a trust. These trusts are irrevocable non-grantor trusts for income tax purposes, but not estate tax purposes, and are established in a state without a state income tax by residents of a state with a high state income tax to avoid state income tax on the sale of highly appreciated assets.

Each trust in this series of letter rulings had a corporate trustee which was the sole trustee. The trustee was required to distribute income and principal to any of the grantor and other specified permissible beneficiaries as directed by either a distribution committee or the grantor in the following circumstances. First, the trustee, pursuant to a direction by majority of the distribution committee, with the written consent of the grantor, could distribute income and principal to any permissible beneficiary ("grantor's consent power"). Second, the trustee, pursuant to the unanimous direction of the distribution committee by a unanimous vote, could distribute net income to the permissible beneficiaries (unanimous member power); and third, the trustee could distribute to any of the permissible beneficiaries other than the grantor, any principal of the trust directly for the health, education, maintenance or support of the permissible beneficiaries as the grantor would direct (grantor's sole power). The grantor's exercise of the grantor's sole power, pursuant to the terms of the trust, was exercisable in a non-fiduciary capacity.

The trust provided that there must be at least two members of the distribution committee. The grantor could not serve as a member of the distribution committee. The distribution committee was to consist of two adults who were also permissible beneficiaries and would act in a non-fiduciary capacity. The grantor was given a broad testamentary limited power of appointment.

The Internal Revenue Service first rule that the trust would not be treated as a grantor trust for income tax purposes under any of Sections 673, 674, 676, or 677 with respect to the grantor. In addition none of the distribution committee members would be treated as the grantor of the trust for income tax purposes under Section 678. The Service also said that the operation of the trust would determine whether the grantor would be treated as the owner of any portion of the trust under Section 675 which treats a trust as a grantor trust for income tax purposes if the administrative control is exercisable primarily for the benefit of the grantor rather than for the beneficiaries of the trust. The Service next ruled that the contribution of property to the trust by the grantor would not be a completed gift subject to federal gift tax. Finally, the Service ruled that, because the powers held by the distribution committee members under the grantor's consent power were exercisable only in conjunction with the creator, the members of the distribution committee would not possess any powers of appointment. In addition, the powers held by the distribution committee members as part of the unanimous member powers were not general powers of appointment because the distribution committee members had substantial adverse interests in the property subject to the power. As a result, any distribution made from the trust to a beneficiary other than the grantor would be considered gifts by the grantor.

14. Cavallaro v. Commissioner, T.C. Memo 2014-189; appealed July 6, 2015

Appeal of case in which Tax Court held that husband and wife are liable for gift tax following company merger

On July 6, 2015, in a gift tax case, the taxpayers appealed the adverse decision of the Tax Court in Cavallaro v. Commissioner, T.C. Memo 2014-189.

In 1979, Mr. and Mrs. Cavallaro started Knight Tool Company. Knight was a contract manufacturing company that made tools and machine parts. In 1982, Mr. Cavallaro and his eldest son developed an automated liquid dispensing machine they called CAM/ALOT. Subsequently, in 1987, Mr. and Mrs. Cavallaro's three sons incorporated Camelot Systems, Inc., which was a business dedicated to the selling of the CAM/ALOT machines made by Knight. The two companies operated out of the same building, shared payroll and accounting services, and collaborated in the further development of the CAM/ALOT product line. Knight funded the operations of both companies and paid the salaries and overhead costs for both.

In 1994, Mr. and Mrs. Cavallaro sought estate planning advice from a big four accounting firm and a large law firm. The professionals advised Mr. and Mrs. Cavallaro that the value of CAM/ALOT Technology resided in Camelot (the sons' company) and not in Knight and that they should adjust their estate planning. Mr. and Mrs. Cavallaro and their three sons merged Knight and Camelot in 1995 and Camelot was the surviving entity. Part of the reason for the merger was to qualify for Conformite Europeenne, which means European conformity, so that the CAM/ALOT machines could be sold in Europe. In the 1995 merger, Mrs. Cavallaro received 20 shares, Mr. Cavallaro received 18 shares, and 54 shares were distributed to the three sons. In valuing the company, the accounting firm assumed that the premerger Camelot had owned the CAM/ALOT technology. The Tax Court found that Camelot had not owned the CAM/ALOT technology, and as a result, the Tax Court found that the appraiser overstated the relative value of Camelot and understated the relative value of Knight at the time of the merger.

In 1996, Camelot was sold for $57 million in cash with a contingent additional amount of up to $43 million in potential deferred payments based on future profits. No further payments were made after the 1996 sale. Three issues were under review by the tax court:

1. Whether the 19 percent interest received by Mr. and Mrs. Cavallaro in Camelot Systems, Inc., in exchange for their shares of Knight Tool Company in a tax free merger, was full and adequate consideration, or whether it was a gift.

2. Whether Mr. and Mrs. Cavallaro were liable for additions to tax under Section 6651(a)(1) for failure to file gift tax returns for 1995, or whether the failure was due to reasonable cause.

3. Whether there were underpayments of gift tax attributable to the gift tax valuation understatement for purposes of the accuracy related penalty, or whether any portions of the underpayment were attributable to reasonable cause.

With respect to the valuation issue, the Cavallaros offered two experts regarding the value of the combined entity. One expert valued the entity at between $70 million and $75 million and opined that only $13 million to $15 million of that value was attributable to Knight. A second appraiser valued the combined entity at $72.8 million.

The IRS retained its own appraiser. This appraiser assumed that Knight owned the CAM/ALOT technology. He valued the combined entities at approximately $64.5 million and found that 65 percent of that value, or $41.9 million, was Knight's portion.

In reaching its decision on the gift tax liability, the Tax Court noted that the 1995 merger transaction was notably lacking in arm's-length character and Camelot may have been a sham company. It also discussed how the law firm in 1995 had tried to document the ownership of the CAM/ALOT technology by the sons but that such documentation was insufficient. The Court did not accept the testimony of the accounting firm. It noted that the IRS had conceded during the litigation that the value of the combined entities was not greater than $64.5 million and that the value of the gift made in the merger transaction was not greater than $29.6 million. As a result, the Tax Court concluded that Mr. and Mrs. Cavallaro made gifts totaling $29.6 million in 1995.

The Tax Court rejected the imposition of penalties for failure to file a gift tax return and accuracy-related penalties. It found that in both instances, Mr. and Mrs. Cavallaro had been advised by an accountant or lawyers and that there was reasonable cause for the failure to file a gift tax return and failure to pay the appropriate amount of tax. It noted that Mr. and Mrs. Cavallaro relied on the judgment and advice of the professional advisors and that the CAM/ALOT technology had been owned by the sons' company since 1987 (and thus was not being transferred in 1995). In documenting its finding of reasonable cause to avoid the penalties, the Tax Court went into great detail about Mr. and Mrs. Cavallaro's lack of formal education beyond high school and that they had built the business themselves.

In their appeal, Mr. and Mrs. Cavallaro argued that the IRS had no basis for alleging that Camelot was a sham corporation and that the Tax Court had been wrong with respect to which

assets were owned by Knight as compared to Camelot. This is a case in which the IRS took an aggressive position and it will be interesting to see how the First Circuit decides this case.

15. Steinberg v. Commissioner, 145 T.C. No. 7 (September 16, 2015)

Value of a gift was decreased by the recipient's assumption of potential estate liability by reason of gross up for gift tax paid under section 2035(b) if the donor dies within three years of the gift by applying the willing buyer and willing seller test combined with the IRSs actuarial mortality and interest tables

A mother entered into a binding gift agreement (the "net gift agreement") with her daughters. Under the net gift agreement, the mother gave certain property to her daughters, and the daughters agreed to assume and pay any gift tax liability imposed due to the gifts. In addition, the daughters agreed to assume and pay any estate tax liability imposed under Section 2035(b) as a result of the gifts, if the mother passed away within three years of the gifts.

The net gift agreement was the result of several months of negotiation, and the mother and the daughters were represented by separate counsel. In determining the fair market value of the property, the mother retained an appraiser, who valued the property based on the assumption of the potential tax liability by the daughters.

The mother filed a gift tax return, and the IRS issued a notice of deficiency. The IRS disallowed the discount that the mother had claimed for her daughters' assumption of potential estate tax liability, and the IRS increased the value of the gift from $71,598,056 to $75,608,963, for an increase in gift tax liability of $1,804,908.

The IRS argued that the daughters' assumption of contingent estate tax liability was not additional consideration in money or money's worth, and argued that the value of the gift should not be reduced by such amount. The court had earlier denied summary judgment on this issue, concluding that this question would be determined by material facts that were the subject of a genuine dispute.

The court cited prior case law in which courts had found that a willing buyer would require that certain potential tax liabilities, such as built-in capital gains, should be factored into a valuation. The court concluded that the daughters' assumption of the potential estate tax liability was a detriment to the daughters, and was a benefit to the donor. The court concluded that it was proper for the appraiser to consider the value of the contingent estate tax liability assumed by the daughters, based on the mother's life expectancy based on actuarial tables promulgated by the Commissioner of Internal Revenue.

16. United States v. Marshall, 798 F.3d (5th Cir. August 19, 2015)

Heirs are not liable for gift tax and interest beyond value of resulting indirect gift

In 1995, J. Howard Marshall, II sold his stock in Marshall Petroleum, Inc. back to the company for a price that the court later determined was below its fair market value. This resulted in an increase in the value of the stock of the remaining shareholders. Shortly after the sale, J. Howard

died. The IRS and J. Howard's estate entered into a stipulation that determined the value and recipients of the indirect gifts, but J. Howard's estate did not pay the gift tax. The IRS attempted to collect the unpaid gift tax from the donees of the transfers.

At the time of the sale, five individuals or entities held MPI Stock, including Eleanor Pierce Stevens (J. Howard's ex-wife who was the beneficiary of a trust funded with MPI stock), E. Pierce Marshall (J. Howard's son), Elaine T. Marshall (E. Pierce's wife), and separate trusts for the benefit of J. Howard's two grandchildren. Stevens was the beneficiary of a grantor retained income trust which paid income to Stevens. As part of her divorce settlement with J. Howard Marshall, Stevens received shares of MPI stock. In 1984, she transferred all of her shares of MPI to a living trust and a few years later, the living trust split those shares into four trusts. Half of the shares were transferred to three charitable remainder annuity trusts and the remaining shares were put into the grantor retained income trust which was to pay income to Stevens for ten years and then pass the assets to E. Pierce who was the remainder beneficiary. When the MPI shares were transferred to the three charitable remainder annuity trusts and the grantor retained income trust, the shares were cancelled and then re-issued in the name of the four trusts.

E. Pierce passed away in 2006 and Stevens passed away in 2007. The IRS audited J. Howard's gift taxes for 1992 through 1995. As a result, after years of back and forth negotiation, the estate and the IRS entered into a stipulation and found that Marshall made substantial indirect gifts to the other shareholders as a result of the 1995 sale of shares of MPI back to the company. The IRS found that the amounts of the gifts were the following:

$43,768,091—E. Pierce

$35,939,316—Stevens

$1,104,165—Elaine

Trusts for the two Grandchildren—$2,208,830

In 2008, the Tax Court issued decisions finding deficiencies in J. Howard's gift taxes. J. Howard's estate never paid the gift taxes. In 2010, the government brought an action in district court against E. Pierce's Estate, Elaine, the trusts for the two grandchildren and Steven's estate. In 2010, E. Pierce's estate paid the gift taxes owed on the gifts to E. Pierce, Elaine, and the trusts for the two grandchildren. Stevens' estate paid nothing toward the gift tax.

When Stevens passed away in 2007, her grandson, E. Pierce, Jr., became the executor of her estate and Finley L. Hilliard was trustee of her living trust. Both were aware that Stevens' estate and the living trust could be held liable for the unpaid gift tax. Before paying anything toward the unpaid gift tax, E. Pierce, Jr. made distributions of personal property from Stevens' estate and also paid rent on Stevens' apartment for one year. Hilliard used funds from the living trust to pay accounting and legal fees for charitable organizations other than the living trust. E. Pierce, Jr. and Hilliard filed a joint income tax return for the living trust and the estate and also permanently set aside $1,119,127 for charitable purposes.

In a prior opinion, United States v. Marshall, 771 F.3d 854 (November 10, 2014), the court held that the beneficiaries was liable for all accrued interest as a transferee.

The August 19, 2015 opinion withdraws that prior opinion. The August 19, 2015 opinion holds that the heirs are not liable for gift tax and interest beyond the value of the resulting indirect gift from the decedent donor on which he did not pay gift tax. The court concluded that a donee's liability for a donor's unpaid gift tax and interest is capped at the amount of the gift, under Section 6342(b), which provides a lien to secure the payment of gift taxes.

17. Estate of Edward Redstone v. Commissioner, 145 T.C. No. 11 (October 26, 2015) and Sumner Redstone v. Commissioner, T.C. Memo 2015-237 (Dec. 9, 2015)

Transfers by two brothers in same factual situation produce different gift tax results

In 1959, to consolidate their family drive-in movie theater businesses and make it easier to obtain financing, Michael ("Mickey") Redstone and his two sons, Sumner and Edward, formed National Amusements, Inc. (NAI). They each contributed to NAI their stock in predecessor entities, and Mickey also contributed $3,000 in cash. Taking the stock contributions into account at their book values, the contributions totaled $33,328 (47.88%) from Mickey, $18,445 (26.49%) from Sumner, and $17,845 (25.63%) from Edward, but 100 shares of NAI common stock were issued to each of them. They all worked in NAI; Mickey was the president, Sumner was the vice president, and Edward was the secretary-treasurer. As the Tax Court described it, "Mickey gave Sumner, his elder son, the more public and glamorous job of working with movie studios and acquiring new theaters. Edward had principal responsibility for operational and back-office functions. His duties included maintaining existing properties and developing new properties." (Sumner recently resigned as the executive chairman of Viacom and CBS.)

In the late 1960s, Edward began to feel marginalized within both his extended family and the business. When he and his wife concluded that it was necessary to have their son admitted to a hospital as a psychiatric patient, Mickey, Mickey's wife, and Sumner opposed that action, "in part" as the court put it "because they feared it reflected badly on the Redstone family name." Edward also became dissatisfied with his role at NAI and with what he viewed as Mickey's and Sumner's disregard for his views in making certain business decisions. He quit the business, demanded possession of the 100 shares of common stock registered in his name, and threatened to sell that stock to an outsider if NAI did not redeem the shares at an appropriate price. Mickey refused to give Edward his stock certificates, contending that NAI had a right of first refusal to buy them back. Mickey also claimed that at least half of the stock registered in Edward's name was actually held under an "oral trust" for the benefit of Edward's children, representing the "extra" shares he accorded to Edward in 1959 when he had contributed 48 percent of NAI's capital but received only 33.33 percent of its stock.

After the parties negotiated for six months, Edward filed suit, and the public nature of the very adversarial litigation was extremely distressing to the Redstone family. Finally, in 1972, they reached a settlement whereby Edward would separate from NAI, one-third of the stock registered in his name (33⅓ shares) would be treated as having always been held in trust for his children, and NAI would buy his remaining 66⅔ shares for $5 million.

As required by the settlement agreement, Edward contemporaneously executed two irrevocable declarations of trust for the benefit of each of his two children and transferred 16⅔ shares of NAI stock to each of the trusts. Three weeks later, Sumner similarly executed irrevocable declarations of trust for the benefit of each of his two children and transferred 16⅔ shares of NAI stock to each of the trusts. Neither Edward nor Sumner filed gift tax returns for the taxable periods (the calendar quarters) in which they made these 1972 transfers.

In 2006, Mickey and the trustees of certain Redstone family trusts sued Sumner, Edward, and NAI in a Massachusetts court, arguing that more stock should have been transferred to the trusts in 1972 on the basis of the existence of a prior "oral trust." In that litigation, Edward testified that he firmly believed that he was entitled to all 100 shares of NAI stock that were originally registered in his name, but that he had accepted his lawyer's advice that it was in his best interest to agree to the oral trust for his children that Mickey had insisted on, in order to settle the earlier litigation and obtain payment for his remaining 66⅔ shares. Sumner testified that Mickey had never asserted such an oral trust in his case and that he had placed one-third of his stock in trust for his children "voluntarily, not as the result of a lawsuit," stating that "I just made an outright gift." In O'Connor v. Redstone, 896 N.E.2d 595 (Mass. 2008), the court held that the plaintiffs had failed to prove that any oral trust ever existed.

The IRS heard about the 2008 case and, in 2010, asserted two $737,625 gift tax deficiencies on the 1972 transfers, one on Edward for the transfers to trusts for his children and one on Sumner for the transfers to trusts for his children.

In Estate of Edward Redstone v. Commissioner, the Tax Court (Judge Lauber) held that Edward's 1972 transfers were not taxable gifts, but rather transfers in the ordinary course of a trade or business, because they were part of the settlement of a claim of an oral trust that "had sufficient plausibility to generate a great deal of litigation over the course of many years," even though it was rejected by the Massachusetts court 37 years later.

In Sumner Redstone v. Commissioner, T.C. Memo 2015-237 (Dec. 9, 2015), Sumner argued that his transfer to the trusts for his children should also escape gift tax. The Tax Court (again Judge Lauber) found Sumner's argument unpersuasive. It distinguished Sumner's situation from Edward's situation in 1971 to 1972 by pointing out that Mickey and Sumner were working to drive Edward out of the business. There was no dispute between Mickey and Sumner as there was between Mickey and Edward.

Despite the differences in motivation between Edward's and Sumner's transfers, the Tax Court found the redemption price paid to Edward for his shares in 1972 to be a reliable index of the value of the stock when Sumner made his gifts. The court also held that Sumner was not liable for the penalties the IRS had asserted.

In any event, these two cases illustrate the principle that intrafamily transfers that would otherwise be taxable gifts (Sumner's transfers) might not be taxable gifts if they result from an arm's-length settlement of a bona fide dispute (Edward's transfers).

ESTATE INCLUSION

18. New York State Department of Taxation and Finance Advisory Opinion TSB-A-15(1)M (May 29, 2015)

Membership interest in a single member LLC, which is disregarded for income tax purposes, is not "intangible property" for New York State estate tax purposes

In this advisory opinion, a petitioner residing in New York State considered forming a single member limited liability company under Delaware law for the sole purpose of contributing his condominium, which was located in New York State, to the limited liability company and then moving to another state. The petitioner intended to remain as the sole owner of the limited liability company for the remainder of his life and to reside outside of New York State until his death. The petitioner's question assumed that the proposed single member limited liability company would be disregarded for income tax purposes and would not be treated as a corporation under Treas. Reg. § 301.7701-3(c).

The New York State estate tax is imposed on the transfer by the estate of a non-resident decedent of real property and tangible property physically located in New York State. As a result, condominiums constitute real property and are generally subject to New York State estate tax. However, where real property, including condominiums, is held by a corporation, partnership, or trust, the interest in such an entity had been held by the courts to be intangible property. See Estate of Havemeyer, 17 N.Y.2d 216 (1966) and In the Matter of Finkelstein, 40 Misc.2d 910 (N.Y. Surr. Ct. Rockland County 1963). The New York Tax Law also defines "tangible personal property" to exclude various property including shares of stock and cash. Under Section 7701, the default classification of a single member limited liability company is that an entity is disregarded for income tax purposes is not deemed to be an entity separate from its owner. Consequently, in situations where a single member limited liability company is disregarded for federal income tax purposes, it will be treated as owned by the individual owner and the activities of the single member limited liability company are treated as the activities of the owner. Therefore, this Advisory Opinion ruled that the interest in the single member limited liability company, which is treated as a disregarded entity, would be treated for New York estate tax purposes as real property held by the petitioner and subject to New York State estate tax. It would not be treated as an intangible asset.

However, the Opinion noted that where a single-member LLC makes an election to be treated as a corporation pursuant to Treas. Reg. § 301.7701-3(c), rather than being treated as a disregarded entity, such ownership interest would be considered intangible property for New York State estate tax purpose.

VALUATION

19. Proposed Regulations under Section 2704, 81 Fed. Reg. 51413 (August 4, 2016)

Proposed Section 2704 Regulations would impose major restrictions on valuation discount planning

Long-awaited proposed regulations under Section 2704 of the Internal Revenue Code, released on August 2, 2016, would make sweeping and very significant changes to the valuation of interests in many family-controlled entities for estate, gift, and generation-skipping transfer tax purposes. The primary focuses of the proposed regulations are treating the lapse of voting or liquidation rights as an additional transfer and disregarding certain restrictions on liquidation in determining the fair market value of a transferred interest.

Background. In 1990, Congress enacted Section 2704 of the Internal Revenue Code, entitled "Treatment of Certain Lapsing Rights and Restrictions," in an effort to limit the valuation discounts for gift and estate tax purposes applicable in the case of intra-family transfers of interests in family-owned, or "closely-held," corporations and partnerships. If an individual and the individual's family hold voting or liquidation control over a corporation or partnership, Section 2704(a) provides, in general, that the lapse of a voting or liquidation right shall be taxed as a transfer subject to gift or estate tax. Section 2704(b) provides, in general, that when an interest in a family-owned corporation or partnership is transferred within the family, if a restriction limits the ability of the corporation or partnership to liquidate and that restriction can be removed by the family, that restriction is disregarded in valuing the transferred interest for gift or estate tax purposes.

Finally, in Section 2704(b)(4), Congress authorized Treasury to issue regulations providing "that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee."

Tax professionals have been expecting these regulations for many years. Treasury and the Internal Revenue Service (IRS) have included these regulations as a project in their Priority Guidance Plan every year since 2003. From 2009 until 2012, the regulatory project was supplemented in the Administration's annual budget proposals by a recommendation that Congress clarify or enlarge Treasury's regulatory authority to disregard other restrictions, referred to as "disregarded restrictions," to be measured by standards provided in regulations. This request for legislative action was dropped in 2013 after it failed to gather support. Meanwhile, the Section 2704(b) regulatory project continued to appear in every annual Treasury-IRS Priority Guidance Plan.

The Proposed Regulations. The IRS released the Section 2704 proposed regulations on August 2, 2016, and they were published in the *Federal Register* on August 4. 81 Fed. Reg. 51413-51425 (Aug. 4, 2016). If and when finalized, the proposed regulations would:

Treat as an additional transfer the lapse of voting and liquidation rights for transfers made within three years of death of interests in a family-controlled entity, thereby eliminating or substantially limiting the lack of control and minority discounts for these transfers;

Eliminate any discount based on the transferee's status as a mere assignee and not a full owner and participant in the entity;

Disregard the ability of most nonfamily member owners to block the removal of covered restrictions unless the nonfamily member has held the interest for more than three years, owns a substantial interest in the entity, and has the right, upon six months' notice, to be redeemed or bought out for cash or property, not including a promissory note issued by the entity, its owners, or anyone related to the entity or its owners;

Disregard restrictions on liquidation that are not mandated by federal or state law in determining the fair market value of the transferred interest; and

Clarify the description of entities covered to include limited liability companies and other entities and business arrangements, as well as corporations and partnerships.

If the final regulations are similar to the proposed regulations, taxpayers will have lost a significant estate planning technique, and the tax cost of transferring interests in family-owned entities will increase.

Lapse of Voting or Liquidation Rights. Treasury and the IRS have been concerned that taxpayers are able to structure transfers of interests in a family-owned entity so that the transferees would not individually have the power to liquidate or control the entity but the transferees together would be able to control or liquidate the entity. Thus, the transferor's right to control or liquidate the entity would not pass to any of the transferees individually and would not be subject to transfer taxes. Because the transferees do not have voting control or the right to liquidate the entity, the values of the transfers for transfer tax purposes are reduced by lack of control or minority interest discounts that could range from 30 to 50 percent or even higher.

Section 2704(a) treats the lapse of a voting or liquidation right in a family-owned entity as a transfer by the individual holding the right immediately before its lapse. The current regulations exempt such a transfer if the rights with respect to the transferred interest are not restricted or eliminated. The proposed regulations would deny that exemption for transfers occurring within three years before the transferor's death if the entity is controlled by the transferor and members of the transferor's family immediately before and after the lapse. Although the informal legislative history of Section 2704 states that the enactment of Section 2704 in 1990 was not intended to eliminate minority or lack of control discounts, the proposed regulations apparently would now have that effect in some cases.

The proposed regulations modify an example in the regulations to illustrate the impact of this provision. An individual owning 84 percent of the stock in a corporation whose bylaws require at least 70 percent of the vote to liquidate gives one-half of the individual's stock in equal shares to the individual's three children. The individual in this example gave up the individual's right to liquidate or control the corporation by making the gift. The example provides that if these

transfers had occurred within three years of the individual's death, the transfers would have been treated as if the lapse of the liquidation right occurred at the individual's death. The result is tantamount to including in the transferor's gross estate an additional "phantom asset" that will not qualify for the estate tax marital or charitable deduction.

Disregarding Certain Restrictions on Redemption or Liquidation. The proposed regulations would also make significant changes to the valuation for transfer tax purposes of interests in a family-controlled entity that are subject to restrictions on redemption or liquidation – that is, subject to limitations on the ability of the owner of the interest to require the entity or other owners to redeem or buy out that owner. The overall effect of Section 2704(b) is that specified restrictions are disregarded in valuing such an interest for gift or estate tax purposes when that interest is transferred to a family member. Under the proposed regulations, the threshold element of the new type of disregarded restriction is still the fact that after the transfer the restriction will lapse or can be removed by the transferor or any member or members of the transferor's family. For this purpose, interests held by nonfamily members, which otherwise might give those nonfamily members the power to prevent the removal of a restriction, are disregarded unless those interests have been held for at least three years, represent at least 10 percent of the entity (and 20 percent in the aggregate with other nonfamily members), and can be redeemed by the nonfamily holder on no more than six months' notice.

But rather than describing the *kinds* of such lapsing or removable restrictions that will be disregarded in making such valuations, the proposed regulations define those restrictions with reference to the *effect* they would have on gift or estate tax value. If the effect of a restriction on an interest in an entity is to limit the ability of the holder of that interest to compel liquidation or redemption of that interest on no more than six months' notice for cash or property equal at least to what the proposed regulations call "minimum value," then the restriction is disregarded. "Minimum value" is defined as the pro rata share of the net fair market value of the assets of the entity – that is, the fair market value of those assets reduced by the debts of the entity, multiplied by the share of the entity represented by that interest. Because the valuation of interests when those restrictions are disregarded is still a complex matter, these rules do not mean that all interests in entities will necessarily be valued on a "look-through" basis at their pro rata share of the net value of the assets of the entity, but the proposed regulations would certainly move much closer to such a model.

The property for which the interest may be redeemed at the holder's election cannot include a promissory note or other obligation of the entity, its owners, or persons related to the entity or its owners, except for a note issued by an entity engaged in an active trade or business that, as the proposed regulations state, "is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds." It is very significant that the proposed regulations specify "market interest rates" and "fair market value," rather than an "applicable federal rate" or other objective rate determined from published sources and a value inferred from the use of such a rate. This small difference in wording is likely to produce a huge difference in the ease of administration of these new rules.

Restrictions Imposed or Required by Law. Section 2704 exempts restrictions on the owners' ability to liquidate the entity "imposed or required to be imposed, by any Federal or State law."

The current regulations state that "[a]n applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction" (often referred to as the "default" state law). When Section 2704 was enacted and the current regulations were issued, the state law applicable to partnerships granted owners certain rights to liquidate the entity. Since then, state legislatures have tightened their default laws, appearing to support provisions in partnership agreements that more significantly restrict the liquidation rights of the owners. Tax advisors have taken advantage of those state laws to increase the restrictions in partnership agreements so as to decrease the transfer tax value of partnership interests. Because those restrictions were consistent with the default state law, the restrictions were not applicable restrictions and were respected for transfer tax purposes.

The proposed regulations would provide, in effect, that a default state law restriction that may be superseded by the governing documents is not a restriction imposed or required to be imposed by Federal or state law. Because most states allow the governing documents of an entity to override any restrictions on transfer, there will be few if any applicable restrictions that will reduce the value of an interest in a family-controlled entity for transfer tax purposes if the proposed regulations become final.

Covered Entities. Although Section 2704, when it was enacted, referred only to corporations and partnerships, the proposed regulations would clarify that they also apply to limited liability companies and other entities and business arrangements, as well as corporations and partnerships.

Effective Dates. The provisions of the proposed regulations applicable to voting and liquidation rights are proposed to apply to rights and restrictions created after October 8, 1990, but only to transfers occurring after the date the regulations are published as final regulations. The new rules described above under the heading "Disregarding Certain Restrictions on Redemption or Liquidation" will not take effect until 30 days after the date the regulations are published as final regulations.

There will be significant comments to the proposed regulations and lively discussion at the public hearing scheduled for December 1, 2016. The earliest the regulations will likely become final will be sometime in 2017.

Immediate Planning. Clients who are considering transferring interests in family-controlled entities that are not controlling interests and do not have liquidation rights should consider making the transfers as soon as possible. It is possible, however, that if the client dies within three years of the transfer and after the date that the proposed regulations become final, the client may be caught by the final regulations. The proposed regulations would also apply to determine and measure any gift component of transfers otherwise structured as sales. Likewise, clients who have recently made transfers and die after the regulations are finalized but within three years of the transfer may be caught by the final regulations.

Long-Term Planning. Because of the broad sweep of the proposed regulations, there will be challenges to Treasury's authority to adopt them in their present form. Meanwhile, attention should be given to the provisions in existing and future operating agreements and other

governing documents and also to the source for payment of the tax on any potential "phantom asset."

20. Pulling v. Commissioner, T.C. Memo 2015-134 (July 23, 2015)

Tax Court upheld taxpayer's valuation of contiguous parcels of real estate, rejecting the IRS' arguments that the properties should be valued as a single unit

The sole issue of contention between the IRS and the decedent's estate was the valuation of three parcels of real estate. These parcels were held by certain corporate entities, which in turn were owned in whole or in part by the decedent. Upon the decedent's death, the IRS determined a deficiency of estate tax in the amount of $1,155,065.

The IRS argued that the three parcels should be valued as a single unit. The court looked to state law to determine the extent of the estate's property interests in the real estate, and the extent to which it was proper to treat the properties as a single unit. The court agreed that assembling the properties into one unit would yield the greatest value, but the court concluded that assembling the properties was not reasonably likely, because of the facts and circumstances of the entities which held the properties.

The court upheld the estate's valuation of the parcels, which had value the parcels as separate parcels and thus at a lower total value than had the parcels been treated as one single parcel.

21. Estate of Purdue v. Commissioner, T.C. Memo. 2015-249

Contribution of assets to a family-owned LLC was a bona fide sale for adequate and full consideration and the value of the LLC assets was excluded from the transferor's gross estate

In this first FLP/LLC Section 2036 case since 2012, the decedent and her husband, residents of Washington State with five children and many grandchildren and great-grandchildren, created the Purdue Family LLC (PFLLC) in August 2000. In November 2000, they transferred to the PFLLC $22 million of marketable securities, an interest in a commercial building in Honolulu valued at approximately $900,000, a $375,000 promissory note from one of their children, and an $865,523 certificate of deposit, in exchange for 100% of the interests in the PFLLC. Mr. Purdue died in August 2001, and much of his undivided 50% share in the Purdues' community property went into two QTIP trusts.

At the time of Mrs. Purdue's death in November 2007, about two-thirds of the interests in the PFLLC were owned by the decedent outright (24.9247%) and the QTIP trusts (42.1608%). The rest of the interests were owned by a family trust (20.7615%), the Purdue children (7.2969%), and a bypass trust created at Mr. Purdue's death (4.8561%). The IRS argued that Section 2036(a) applied with respect to the decedent's transfers to the PFLLC. The Tax Court agreed with the estate that the transfers were bona fide sales for adequate and full consideration and therefore Section 2036(a) did not apply.

Citing Estate of Bongard v. Commissioner, 124 T.C. 95 (2005), and Estate of Liljestrand v. Commissioner, T.C. Memo. 2011-259, the court first separated the true nontax reasons for the PFLLC's formation from those that merely clothed transfer tax savings motives. The estate argued that decedent had seven nontax motives for transferring the property to the PFLLC:

(1) to relieve decedent and Mr. Purdue from the burdens of managing their investments;

(2) to consolidate investments with a single adviser to reduce volatility according to a written investment plan;

(3) to educate the five Purdue children to jointly manage a family investment company;

(4) to avoid repetitive asset transfers among multiple generations;

(5) to create a common ownership of assets for efficient management and meeting minimum investment requirements;

(6) to provide voting and dispute resolution rules and transfer restrictions appropriate for joint ownership and management by a large number of family members; and

(7) to provide the Purdue children with a minimum annual cash flow.

The IRS argued that the PFLLC was a testamentary substitute and that transfer tax savings were the primary motivation for the formation and funding of the PFLLC.

The court agreed with the IRS that gift giving alone was not an acceptable nontax motive, but disagreed that gift giving was decedent's only motive in transferring property to the PFLLC. The decedent's desire to have the marketable securities and the Honolulu Building interest held and managed as a family asset constituted a legitimate nontax motive for her transfer of property to the PFLLC. The court cited Estate of Schutt v. Commissioner, T.C. Memo. 2005-126 in which the consolidation of assets was allowed as a legitimate and significant nontax motive to further a buy and hold investment strategy, but noted that this should be compared to Estate of Hurford v. Commissioner, T.C. Memo. 2008-278, in which no advantage was found to consolidating asset management where the partner's relationship to the assets did not change after the formation of a family limited partnership.

Other factors supported the estate's argument that a bona fide sale occurred. 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's funds. Further, the formalities of the PFLLC were respected. The PFLLC maintained its own bank accounts 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 showed that decedent and Mr. Purdue were in good health at the time the transfer was made to the PFLLC. Although decedent was 88 at the time of transfer in 2000, she lived until 2007. Aside from a golf cart accident in 1984 and a stroke or transient ischemic attack in 2000, decedent never experienced any mental illness or life-

threatening illnesses. Mr. Purdue was 83 at the time of the transfer and experienced symptoms of Alzheimer's disease. Otherwise, Mr. Purdue lived an active lifestyle until his death in 2001.

The IRS argued that decedent stood on both sides of the transaction, as Mr. and Mrs. Purdue transferred all of the assets and there were no negotiations over the terms of the PFLLC operating agreement between them and their children. Citing Bongard again, the court noted that "an arm's-length transaction occurs when mutual legitimate and significant nontax reasons exist for the transaction and the transaction is carried out in a way in which unrelated parties to a business transaction would deal with each other."

The court also noted that because "decedent had a legitimate and actual nontax purpose in transferring the property to the PFLLC … the transfer was not merely an attempt to change the form in which decedent held the property and … the full and adequate consideration prong is satisfied."

The court also held that gifts to the family trust subject to Crummey withdrawal rights were gifts of present interests that qualified for the gift tax annual exclusion, and that interest on loans from the PFLLC members to the estate was necessarily incurred by the estate and therefore allowable as a deductible administration expense. Although a distribution from the PFLLC was an option, the PFLLC operating agreement required its members to unanimously approve such a distribution, and one child of the decedent withheld approval, making the loan necessary.

22. Estate of Holliday v. Commissioner, T.C. Memo 2016-51

Value of assets transferred by decedent to family limited partnership included in decedent's estate under Section 2036

Decedent and her husband lived frugally and accumulated substantial assets. At Husband's death, his assets were put in three trusts, apparently a GST exempt marital trust, a non-exempt marital trust, and a credit shelter trust. Decedent was entitled to the income from the two marital trusts and to principal distributions from all three trusts.

In 2003, Decedent moved to a nursing home and named her two sons, Douglas and Joseph, as her agents under a property power of property. Douglas attended to Decedent's day-to-to-day financial needs and Joseph managed the financial assets.

On November 30, 2006, Decedent executed a certificate of limited partnership and a limited partnership agreement for Oak Capital Partners, LP. While describing the purposes of Oak Capital in broad terms, one stated purpose was to provide "a means for the members of the Holliday family to acquire interests in the Partnership business and property, and to ensure that the Partnership's business and property is continued by and closely-held by members of the Holliday family." Oak Capital limited partners could not participate in the business, affairs, or operations of the Partnership.

Also, on November 30, 2006, Decedent executed the organizational papers for a limited liability company called OVL Capital Management, LLC to be the general partner of Oak Capital. Decedent was the sole member of OVL.

On December 6, 2006, Oak Capital and OVL were funded by Decedent with $5,919,683 of marketable securities. This was the only capital contribution. Decedent then owned a 99.9 percent limited partnership interest in Oak Capital and OVL owned a .1 percent interest as the general partner of Oak Capital. Subsequently, on December 6, Decedent made two transfers. First, she sold her .1 percent interest in OVL to her two sons for $2959.84 each based on the undiscounted value of the assets in OVL. Second, Decedent transferred 10 percent of her limited partnership interest in Oak Capital to the 2006 Holliday Irrevocable Trust which she executed on November 30, 2006 (the same day that Oak Capital and OVL were formed).

Until Decedent's death in 2009, the only assets in Oak Capital were investment assets such as marketable securities and cash. The only distribution made by Oak Capital was a $35,000 pro rata distribution to its partners in March 2007. Decedent left the management of her assets to her two sons and her attorney. Decedent died on January 7, 2009 at age 84. Her two sons, Joseph and Douglas, were the personal representatives.

The estate chose the alternate valuation date of July 7, 2009 for valuing the assets in Decedent's estate. The undiscounted value of the assets in Oak Capital on July 7, 2009 was $4,064,759. The discounted value reported on Decedent's estate tax return was $2,428,200. This was a discount of approximately 40 percent. The IRS asserted that the assets in Oak Capital should be taxed in Decedent's estate at full fair market value.

The court applied the analysis used in Estate of Bongard v. Commissioner. 124 T.C. 95 (2005) to determine if Section 2036 applied to tax the assets in Oak Capital in Decedent's estate at full fair market value. Section 2036 will apply if:

1. Decedent made an inter vivos transfer of property;

2. Decedent retained the income from or the use and enjoyment of the property until her death; and

3. The transfer of property was not a bona fide transfer for full and adequate consideration.

The parties agreed that Decedent made an inter vivos transfer, but disagreed on the second and third requirement.

The estate denied that Decedent retained any rights under Section 2036 while the IRS argued that Decedent retained both the right to the income from the property and the right to the use and enjoyment of the property. The IRS also argued that there was an implied agreement that Decedent could access the income from the assets in Oak Capital if needed.

The Tax Court determined that the second requirement was satisfied since the Oak Capital limited partnership agreement provided that periodic distributions were to be made to the partners to the extent that the General Partner determined that Oak Capital had sufficient funds in excess of its current cash needs. The Tax Court found that this provision unconditionally provided that decedent was entitled to receive distributions from Oak Capital in certain conditions. Also, Joseph's testimony made it clear that had Decedent needed a distribution from

Oak Capital, it would have made. As a result, there was an implied agreement that Decedent retained the right to income from and the use and enjoyment of the property in Oak Capital.

With respect to the third requirement, in order to have a bona fide sale for full and adequate consideration, there must be a significant non-tax reason for creating the partnership. The Tax Court rejected each of the three significant non-tax reasons offered by Decedent's estate:

1. Protection from trial attorney extortion or the protection of Decedent's assets from personal injury claims;

2. Protection from the undue influence of caregivers; and

3. Preservation of the assets for the benefit of Decedent's heirs.

The Tax Court found that the first reason was purely a theoretical concern. On the second concern, the Tax Court noted that Joseph did not discuss the possibility of his mother being taken advantage of with his mother as a reason for creating the partnership. The court, with little discussion, also rejected the third reason, since other structures to protect assets were available and Decedent was not involved in selecting the structure used to preserve the assets. Douglas testified at trial that his mother was fine with whatever he, his brother, and the attorney decided upon.

The Tax Court also noted other factors indicating that this was not a bona fide sale. First, Decedent stood on both sides of the transaction. There was no meaningful negotiation or bargaining associated with the formation of the partnership. Second, Oak Capital failed to maintain books and records other than brokerage statements and ledgers maintained by Joseph. Other portions of the limited partnership agreement were ignored.

As a result, the Tax Court found that Section 2036 applied and the assets of Oak Capital were to be included in the estate at full fair market value.

23. Estate of Clara M. Morrissette, 146 T.C. No. 11 (2016)

Split-dollar life insurance arrangements at issue are governed by the economic benefit regime and not the loan regime

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

Under the regulatory scheme put in place in 2003, two mutually exclusive methods for taxing split-dollar life insurance arrangements now apply, the economic benefit regime and the loan

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

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

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

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

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

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

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

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

The court first noted that the 2003 final regulations governed the split-dollar arrangements since they were entered into after September 17, 2003. The court also noted that generally the person named is the owner in the insurance contract is treated as the owner of the contract. Under this general rule, the dynasty trusts would be considered the owners of the policies and the loan regime would apply. However, the final regulations included the special ownership rule that provided that, if the only economic benefit provided under the split-dollar life insurance arrangement to the donee is the current life insurance protection, then the donor will be deemed the owner of the life insurance contract, irrespective of actual policy ownership, and the economic benefit regime will apply.

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

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

24. Estate of Marion Levine v. Commissioner, Docket Number 9345-15

Tax Court follows Morrissette decision

The Tax Court granted the petitioner's Motion for Summary Judgment on the issue that the split-dollar life insurance arrangement at issue was governed by the economic benefit regime and not the loan regime because of the Tax Court's opinion in Estate of Morrissette v. Commissioner, 146 T.C. No. 11 (2016). Levine involves the IRS's imposition of $2.9 million in back taxes and accuracy related penalty of $1.1 million in compensation with the split-dollar financing of life insurance policies in an irrevocable life insurance trust.

The taxpayer argued that Morrissette controlled in this situation and the IRS agreed. The IRS disagreed with the decision in Morrissette and by opposing the Motion for Summary Judgment preserved its right to appeal in Levine.

CHARITABLE GIFTS

25. Balsam Mountain Investments, LLC v. Commissioner, T.C. Memo 2015-43

Partnership's right to change boundaries of a conservation easement causes conservation easement to fail the definition of a "qualified real property interest" and the income tax charitable deduction was denied

Balsam Mountain Investments, LLC granted a perpetual conservation easement to North American Land Trust. The conservation area was defined in the easement as a specific 22-acre parcel of land in Jackson County, North Carolina. Under the easement agreement, Balsam retained the right to make boundary changes to the conservation area. The calculated area of land within the conservation area after any alteration could not be reduced from the original calculated area of land. The land added to the conservation easement had to be contiguous with the current conservation area. No adjustments could be made after the fifth anniversary of the date of the conservation easement. The aggregate land removed from the conservation area as a result of all boundary line alterations could not exceed five percent of the original area within the conservation area.

The IRS contended that the easement was not a "qualified real property interest" of the type described in Section 170(h)(2)(C) and therefore the gift did not meet the requirements of a "qualified conservation contribution." The Tax Court agreed with the IRS, holding that a conservation easement is not a "qualified real property interest" if the easement agreement permits the grantor to change what property is subject to the easement. Balsam tried to distinguish this case from Belk v. Commissioner, 140 T.C. No. 1 (2013). Balsam noted that the easement agreement in Belk allowed the donor to substitute other land for all the land initially subject to easement. Here the easement allowed substitution for only five percent of the land initially subject to the easement. The court declined to agree with Balsam, noting that while the easement was different from the one in Belk, the difference did not matter.

26. Isaacs v. Commissioner, T.C. Memo 2015-121

Donation of twelve fossil trilobites disallowed as income tax charitable deduction because qualified appraisal requirements not met

In 2006, Dr. James Isaacs donated four fossil trilobites to the California Academy of Sciences. In 2007 Dr. Isaacs donated an additional eight fossil trilobites to the California Academy of Sciences.

Dr. Isaacs filed Forms 8283, Non-Cash Charitable Contributions, with his 2006 and 2007 federal income tax returns. On each form, an individual signed on behalf of the California Academy of Sciences to acknowledge that the California Academy of Sciences was a qualified organization and had received Dr. Isaacs' donations in the relevant tax year. Dr. Isaacs included letters from the senior collections manager for geology at the California Academy of Sciences acknowledging the donations with his 2006 and 2007 returns. Both of Dr. Isaacs' Forms 8283 bore the signature "Jeffrey R. Marshall" in the declaration of appraiser. Dr. Isaacs also called Jeffrey R. Marshall as a witness at trial, and the court accepted Mr. Marshall as an expert in the valuation of fossils. Mr. Marshall identified his signature on Dr. Isaacs' 2006 Form 8283 as his own but did not recall signing it. Likewise he identified his signature on Dr. Isaacs' 2007 Form 8283 but could not recall signing the form. Mr. Marshall similarly identified his signature on two letters dated December 31, 2006 and 2007 that purported to be appraisals for the fossils donated by Dr. Isaacs to the California Academy of Sciences in 2006 and 2007. However, Mr. Marshall did not write or even recognize the letters, and, as Dr. Isaacs offered no testimony from any other expert as to the letters' author, the court did not admit them into evidence. Dr. Isaacs did not offer any other reported appraisals of the donated fossils.

For 2006, Dr. Isaacs claimed an $85,894 deduction on the basis of a $136,500 non-cash contribution and an $11,719 carryover from a prior year. For 2007, he claimed a $52,361 deduction on the basis of a $109,800 non-cash contribution and a $62,575 carryover from a prior year. For 2008, he claimed a $14,548 deduction on the basis of cash contributions totaling $500 and a $120,309 carryover from a prior year.

The court found that Dr. Isaacs failed to obtain qualified appraisals of the donated fossils as required by Section 170(f)(11)(c). The court noted that Mr. Marshall denied that he had written the reported appraisals and, as a result, they were not admitted into evidence. In addition, Dr. Isaacs failed to satisfy the recordkeeping requirement. He introduced no evidence other than the Forms 8283 with respect to the valuation of the fossils. This violated the regulations to Section 170 which mandate that as a pre-requisite to a deduction of a non-cash charitable contribution, the taxpayer must maintain records containing information on the approximate date and manner of the acquisition of the fossils and the cost or other basis or the method by which their purported fair market value is determined. Finally, Dr. Isaacs failed to obtain a satisfactory contemporaneous written acknowledgment as required for a contribution exceeding $250. Although Dr. Isaacs received letters from the California Academy of Sciences acknowledging the contribution, they did not state whether the California Academy of Sciences had provided any goods or services in exchange. Consequently the letters could not suffice as contemporaneous written acknowledgement.

The court also imposed accuracy related penalties.

27. Bosque Canyon Ranch, L.P. v. Commissioner, T.C. Memo 2015-130

Income tax charitable deduction for conservation easement was denied

Bosque Canyon Ranch, L.P. ("BCR I"), a Texas limited partnership, was formed in 2003 and owned the Bosque Canyon Ranch, which consisted of 3,744 acres. In 2005, BCR I granted a conservation easement to the North American Land Trust. BCR I sold partnership interests to outsiders which gave each holder a home site. The home site parcel owners and North American Land Trust could, by mutual agreement, modify the conservation easement provided that the modification could not have a "material adverse effect" on any of the conservation purposes. The 2005 easement was valued at $8,400,000. BC Ranch II, L.P. ("BCR II") was formed in December 2005 as a Texas limited partnership. On December 20, 2005, BRC I deeded approximately 1,866 acres of the Bosque Canyon Ranch to BCR II. BCR II granted the North American Land Trust a conservation easement in 2007 relating to 1,732 acres of Bosque Canyon Ranch. The material terms of the 2007 deed were substantially the same as those in BCR I's 2005 deed.

To obtain an income tax charitable deduction for the contribution of a conservation easement, the contribution must meet the requirements of a qualified conservation contribution. In general, a qualified conservation contribution is a contribution of a "qualified real property interest" to a charity for conservation purposes. The 2005 and 2007 deeds permitted modifications to the boundaries between the home site parcels and the property subject to the easements. The IRS contented that the deeds violated the requirement for a conservation easement that the conservation easement be in perpetuity. The court found that the conservation easements did not constitute a qualified real property interest and therefore the income tax charitable deduction should be denied. In addition, the court held BCR I and BCR II liable for gross valuation misstatement penalties under Section 6662(a).

28. Estate of Schaefer v. Commissioner, 145 T.C. No. 4 (July 28, 2015)

Value of Net Income Only Charitable Remainder Unitrusts with Makeup Provisions would be calculated using the greater of five percent or fixed percentage amount

Arthur Schaefer owned a 100% interest in Schaefer Investments, LLC, which he formed on February 21, 2006. The 100% interest consisted of 990 non-voting units and 10 voting units. Schaefer Investments, LLC owned 92.34% of AES Family Limited Partnership and a money market checking account. Also on February 21, 2006, the same date he created Schaefer Investments, LLC, Schaefer created two charitable remainder unitrusts (CRUTs). Schaefer transferred a 49.5% non-voting interest in Schaefer Investments, LLC into each of the two CRUTs. Schaefer was the income beneficiary of both CRUTs. Upon his death, one of his sons became the income beneficiary of the first CRUT and the second son became the income beneficiary of the second CRUT. The CRUTs were for net income only trusts with makeup provisions that provided for payments of the lesser of the net trust accounting income or 11% of the net fair market value of the assets revalued annually for the first CRUT, and 10% of the net fair market value of the assets revalued annually for the second CRUT. Schaefer died in 2007.

The estate did not claim a charitable contribution deduction for any portion of the trusts. Instead, the estate reduced the amounts reported on Schedule G by the amounts it deemed to be charitable contributions. The estate claimed that it was entitled to a charitable contribution deduction for the values of the charitable remainder interests of the two CRUTs. For the estate to be eligible for the deduction, the value of each remainder interest had to be at least 10% of the net fair market value of the property contributed to the trust at the time of the contribution.

The estate and the IRS disagreed about the appropriate distribution amount to use in calculating the values of the remainder interests in the CRUTs. The court held that where the trust payout is the lesser of the trust income or fixed percentage, the parties must use an annual distribution amount equal to the greater of the fixed percentage stated in the trust instrument or 5% to determine whether the estate is eligible for the charitable contribution deduction. The estate had argued that in valuing the remainder interests, the distributions were calculated by using the Section 7520 rate to determine the trusts' expected income, so long as the Section 7520 rate is above 5% of the net fair market value of the assets. The IRS had argued that the remainder interest is valued using a distribution rate equal to the fixed percentage in the trust instrument.

The court found each approach to be arguably flawed. There was no basis for the estate's approach in the statute. The IRS's approach potentially undervalued the remainder interests that would pass to the charitable beneficiary because it assumed the maximum distribution by using the fixed percentage, even though that amount can be distributed only if the trust produces sufficient income. The court found that the text of Section 664 was ambiguous. The IRS guidance in Revenue Ruling 72-395, 1972-2 C.B. 349 provides that notwithstanding a net income makeup provision, the computation of the charitable deduction is determined on the basis that the regular unitrust amount would be distributed in each year of the trust. The court also reviewed the legislative history of the statute. The court noted that the legislative history and the administrative guidance point to only one conclusion, that the value of the remainder interest of a net income charitable remainder unitrust with makeup provisions must be calculated using the greater of 5% or the fixed percentage stated in the trust instrument. As a result, the estate had to use an annual distribution amount of 11% or 10% of the net fair market value of the respective CRUTs. The parties had previously stipulated that the estate would not be entitled to a charitable contribution deduction if the remainder interests were valued using this method.

29. Minnick v. Commissioner, No. 13-73234 (9th Cir. August 12, 2015)

Court denies charitable deduction for conservation easement because outstanding mortgage on the underlying property was not subordinated at the time of the donation to the rights of the holder of the easement

In 2006, the donors donated a conservation easement on certain property. The land was still subject to a mortgage, despite certain warranties in the easement to the contrary. An appraiser valued the conservation easement at $941,000, and the donors claimed a charitable deduction on their income tax returns.

Following review by the IRS, the IRS denied the deduction for the conservation easement, 46.

The court concluded that to qualify for the income tax deduction and to comply with the compliance with the "in perpetuity" requirement of 26 U.S.C. § 170(h)(5)(A), and the more specific subordination requirements of Treas. Reg. § 1.170A–14(g)(2). Because the mortgagee had not subordinated its rights, the conservation easement was subject to extinguishment by a prior mortgage holder, and accordingly the deduction was denied.

30. Palmer Ranch Holdings Limited v. Commissioner, ___ F.3d ___ (11th Cir. 2016)

Court of Appeals reverses Tax Court's valuation of conservation easement for income tax charitable deduction purposes

Palmer Ranch, Inc. owned undeveloped property in Sarasota County, Florida which was home to eagles and "small urban animals of considerably less patriotic interest." To allow the eagles to reach their feeding grounds in Sarasota Bay, the property had a wildlife corridor from the eagles' nests on the property to the coast. Concern over the eagle nests, wildlife corridor and wet lands prevented Palmer Ranch, Inc. from selling the parcel and an adjacent parcel for residential development. Palmer Ranch then donated a conservation easement on the property to Sarasota County. Palmer Ranch valued the parcel at $25,200,000 on the assumption that the highest and best use was residential development with a development of 360 dwelling units being a reasonable possibility.

In the Tax Court proceedings, Palmer Ranch insisted that the parcels' highest and best use was residential development which would permit between 2 and 5 units per acre for 164 to 410 units in total which should produce a value of $25,200,000. The IRS countered with a maximum highest and best use of 100 units and a value of $7,750,000. The Tax Court held in favor of Palmer Ranch on the methodology for determining the highest and best use of the parcel, but valued the property at $21,005,278 instead of $25,200,000.

The Appellate Court affirmed the Tax Court's determination of the highest and best use for the parcel in line with that proposed by Palmer Ranch. The Appellate Court, however, reversed the Tax Court's valuation of $21,005,278. The Appellate Court found that the Tax Court, in reaching a value of $21,005,278, had failed to look at the comparable sales provided by the appraisers for both the taxpayer and the IRS, but instead looked at a 2004 valuation of the parcel. The Tax Court's valuation was premised on an old appraisal as modified by monthly appreciation rates instead of on comparable sales.

The case was remanded to the Tax Court to either use the comparable sales analysis in determining the highest and best use value or explain its departure from the use of the comparable sales method.

31. RP Golf LLC v. Commissioner, T.C. Memo. 2016-80

Tax Court sustains disallowance of $16.4 million deduction for 2003 donation of conservation easement on two private golf courses

RP Golf developed two private golf courses in Missouri which were completed and placed into service between 2000 and 2003. Each golf course organized for profit private golf clubs and National Golf operated both of the golf clubs. Hillcrest Bank financed the original purchase of the property on which the golf courses were located and made a development loan to RP Golf. RP Golf, National Golf, and another related entity granted security interests in all the properties and executed a deed of trust. Earlier development financing was also obtained from Great Southern Bank which also secured its loans with a deed of trust.

On December 29, 2003, National Golf executed a conservation easement on the property. National Golf expressly reserved the right to use the property as a golf course. When National Golf executed the conservation easement on December 29, 2003, the property was subject to senior deeds of trust held by Hillcrest Bank and Great Southern Bank. Written consents subordinating the interests of the two banks were executed by bank officers on April 14, 2004, approximately 100 days after the execution of the conservation easement.

The IRS subsequently disallowed the entire income tax charitable contribution deduction for the conservation easement on the grounds that the creation of the conservation easement failed to satisfy the requirements for an income tax charitable deduction or that the donor failed to establish that the value of the easement was $16,400,000. The IRS then filed a motion for summary judgment asking the court to sustain its disallowance of the income tax charitable deduction. In 2012, in RP Golf LLC et al. v. Commissioner, T.C. Memo 2012-282, the court held that the charitable contribution did not have a charitable purpose within the meaning of Section of 170(h)(4)(A)(iii)(II) requiring a clearly delineated federal, state or local government conservation policy and that genuine issues of material fact remained concerning whether the requirements for a charitable contribution deduction had been met for 2003.

In this case, the court focused on the requirement under Section 170(h)(1) that, in order to have a qualified conservation contribution, the contribution is exclusively for conservation purposes. One requirement is that a contribution shall only be treated as exclusively for conservation purposes if the conservation purpose is protected in perpetuity. RP Golf argued that the conservation purpose of the donated property was protected in perpetuity because both banks had orally agreed to conveyance at the time of the creation of the easement and subsequently subordinated their interests to in writing in the subject property.

The court found that the evidence failed to establish that the oral consent agreements in December 2003 with the two banks regarding the subordination of their interests in the conservation easement property actually subordinated their interests. Only the written subordinations several months later did. Because the property described in the conservation easement was subject to pre-existing unsubordinated mortgages on the date of the grant, the easement was not granted in perpetuity. Consequently, the income tax charitable deduction was disallowed.

32. <u>Carroll v. Commissioner,</u> 146 T.C. No. 13 (2016)

Conservation easement fails to meet the perpetuity requirement of Section 170

In 2005, Husband and Wife contributed a conservation easement on a parcel of land to two charities. The conservation easement provided that, in the event that the conservation purpose was extinguished because of an unexpected change in circumstances surrounding the donated property, the donee organizations were entitled to a proportionate share of the extinguishment proceeds at least equal to the amount allowable as a deduction for federal income tax purposes over the fair market value of the property at the time of the contribution.

The court denied the income tax charitable deduction. Section 170(h) allows an income tax charitable deduction for a "qualified conservation contribution." A qualified conservation contribution requires that the contribution be exclusively for conservation purposes and that the conservation purposes must protected in perpetuity. Treas. Reg. § 1.170A-14(g)(6)(ii) provides that the conservation purpose of a contribution is not protected in perpetuity unless the contribution gives rise to a property right immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift bears the value of the property as a whole at that time. Accordingly, when a change in conditions gives rise to the extinguishment of a perpetual conservation restriction, the donee organization on a subsequent sale, exchange or involuntary conversion of the subject property must be entitled to a portion of the proceeds at least equal to the proportionate value of the perpetual conservation restriction. Here, because the easement provided that the value of the contribution for purposes of determining the charity's rights to the extinguishment proceeds was the amount of the donor's allowable deduction rather than fair market value of the easement, it did not comply with the requirements of the Treasury Regulations and the conservation purpose was not protected in perpetuity as required. Consequently, the income tax charitable deduction was denied and accuracy related penalties were imposed.

33. <u>Estate of Dieringer v. Commissioner</u>, 146 T.C. No. 8 (2016)

Estate tax charitable deduction limited by post-death events

Decedent and family members owned DPI, a closely held real property management corporation. Decedent was the majority shareholder to DPI and owned 425 of the 525 voting shares and 7,736.5 of the 9,920.5 non-voting shares. While she was alive, decedent established a revocable trust and a foundation. Her son was the sole trustee of both the trust and the foundation. Decedent's will left her entire estate to the trust. Pursuant to the terms of the trust, $600,000 was to pass to various charities and decedent's children received minor amounts of her personal effects. The remainder of the estate, which would consist primarily of the DPI stock, was to be distributed to the acting trustee of the foundation. An appraisal determined the date of the death value of decedent's DPI non-voting and voting shares at $14,182,471. The voting stock was valued at $1,824 per share with no discount and the non-voting stock was valued at $1,733 per share which included a 5% discount to reflect the lack of the voting power. Numerous events occurred after decedent's death, but before decedent's property was transferred to the foundation. Seven months after decedent's death, DPI elected S-corporation status. DPI also agreed to

redeem all of decedent's shares from the trust. DPI and the trust amended and modified the redemption agreement. DPI agreed to redeem all 425 of the voting shares and 5,600.5 of the 7,736.5 non-voting shares. In exchange for the redemption, the trust received a short-term promissory note for $2,250,000 and a long term promissory note for $2,968,462. At the same time, three of these of decedent's sons purchased additional shares in DPI. The foundation later reported that it had received three non-cash contributions consisting of the short-term and long-term promissory notes and non-voting DPI shares. The total value of the two promissory notes was $5,218,462.

An appraisal of decedent's DPI stock for purposes of the redemption and subscription agreements determined that the voting shares had a fair market value of $916 per share and non-voting shares had a fair market value of $870 per share. The value of the DPI stock reported as received by the foundation from the trust was $1,858,961. The appraisal of the voting stock included discounts of 15% for lack of control and 35% for lack of marketability. The appraisal of the non-voting stock included the lack of control and marketability discounts plus an additional 5% discount for the lack of voting power at shareholder meetings.

On the federal and state estate tax returns, the estate reported no estate tax liability and claimed an estate tax charitable deduction of $18,812,181 which included the date of death value of decedent's DPI shares. The estate argued that the charitable deduction should not depend upon or be measured by the value received by the foundation. The IRS argued that the amount of the charitable contribution should be determined by post-death events.

The IRS agreed that normally that the value of the estate tax charitable deduction is to be determined as of the moment of death and also agreed that the estate did not elect alternate valuation under Section 2032. It did argue that there are circumstances where the appropriate amount of a charitable contribution deduction does not equal the date of death value of the contributed property, citing Ahmanson Foundation v. US, 674 F.2d. 761 (9th Cir. 1981).

The court agreed with the IRS and found that the value of the charitable contribution to the foundation was less than the date of death market value of bequeathed property because numerous events occurred after decedent's death that changed the nature of and reduced the value of the property actually transferred to the foundation and held that the estate was liable for an accuracy related penalty. The amount of additional estate tax owed was $4,124,717 and the accuracy related penalty was $824,943.

The court noted that the same appraiser valued the DPI stock for purposes of determining the date of death value of the property as well as the value for purposes of the redemption. The appraiser testified that for purposes of the redemption, he was specifically instructed to value that DPI stock as a minority interest. The court found that the brothers had thwarted decedent's testamentary plan by altering the date of death value of decedent's intended donation through a redemption of a majority interest as minority interest. It cited Treas. Reg. § 20.2055-2(b)(1) to the effect that if a trustee "is empowered to divert the property… to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed...the deduction will be limited to the portion, if any, of the property or fund which is exempt from an exercise of the power."

34. Revenue Procedure 2016-42, 2016-34 IRB (August 9, 2016)

IRS issues sample provision to permit a charitable remainder annuity trust to qualify even if it does not meet the probability of exhaustion test

One requirement of a charitable remainder annuity trust is that it must pass the "probability of exhaustion test." This test holds that, if there is a greater than five percent probability that the payment of the annuity will defeat the charity's interest by exhausting the trust assets by the end of the term of the charitable remainder annuity trust, then the possibility that the charitable transfer will not become effective is not so remote as to be negligible. A charitable deduction is only allowed if the possibility that the charitable gift will not become effective is so remote as to be negligible.

Low interest rates in recent years have greatly limited the use of the charitable remainder annuity trust as an effective charitable giving vehicle. The Service notes in this revenue procedure that, in May 2016, the Section 7520 rate underlying the valuation tables is 1.8%. At this interest rate, the sole life beneficiary of a charity remainder annuity trust that provides for the minimum allowable annuity of 5% of the initial fair market value of the trust assets must be at least 72 years old at the creation of the trust to pass the test. The Section 7520 rate has not exceeded the minimum 5% annuity payout since December of 2007 which has necessitated testing for the probability of exhaustion for every charitable remainder annuity trust created since that time.

The sample provision, which applies to a single life charitable remainder annuity trust, but which can be modified for a charitable remainder annuity trust which has more than one private beneficiary, provides an alternative to satisfying the probability of the exhaustion test. The provision will cause the early termination of the charity remainder annuity trust, followed by an immediate distribution of the remaining trust assets to the charitable beneficiary. It provides for early termination of the trust (and thus the end of the ability to make any more annuity payments to the private beneficiary or beneficiaries) on the date immediately before the date on which the annuity payment would be made, if the payment of that annuity amount would result in the value of the trust corpus, when multiplied by a specified discount factor, being less than ten percent of the value of the initial trust corpus.

The revenue procedure is affective after the date of the revenue procedure. A charitable remainder annuity trust that contains a provision similar to the sample provision contained in the revenue procedure will not necessarily be disqualified, but will also not be assured of the favorable treatment.

GENERATION-SKIPPING TRANSFER TAX

35. Letter Ruling 201604001 (Issued August 1, 2015; released January 22, 2016)

Proposed division of irrevocable trust will not have adverse generation-skipping transfer tax purposes

Husband and Wife created a trust for the benefit of their three children after the 1985 effective date of the generation-skipping tax. The settlors allocated sufficient GST exemption to fully exempt the trust. The trustees proposed to divide the assets of the trust into three separate equal trusts for each of the three children and each child's respective issue. Each separate trust would have the same provisions as the original trust except that it would be solely for the benefit of the child for whom the trust would be named and the child's issue. Each separate trust would be funded with one-third of each asset currently held by the original trust and each separate trust would be subject to the same terms and conditions as the original trust.

The Service noted that under Section 2601, a modification of an exempt trust by judicial reformation or non-judicial reformation that is valid under applicable state law will not cause an exempt trust to lose its exemption if the modification does not shift a beneficial interest in the trust to a beneficiary in a lower generation and if the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. These rules apply to grandfathered trusts. The Service found that the same rule should apply to exempt trusts and because the division of the original trust into the three separate trusts would not shift a beneficial interest to a lower generation and it would not extend the time for the vesting of any beneficial interest, there would not be adverse generation-skipping tax consequences.

36. Letter Ruling 201536012 (Issued May 22, 2015; released September 4, 2015)

Transfers to two grandchildren of the taxpayer were not subject to GST tax because the person who was the parent of the grandchildren and child of the taxpayer was deceased at the time of the transfers; accordingly, allocation of GST tax exemption to transfers was void

Under the facts of this private letter ruling, the taxpayer and his spouse made outright gifts to the deceased child's children two grandchildren. The grandchildren's parent, a child of the taxpayer and his spouse, had died before the gifts. The taxpayer and his spouse split the gifts to the grandchildren, and on their gift tax returns, the taxpayer and his spouse allocated GST tax exemption to the transfers.

Following the taxpayer's death, the executor of the taxpayer's estate requested a ruling that the allocation of GST exemption to the gifts were null and void, because there was no GST tax potential with respect to those transfers.

Under Treas. Reg. § 26.2632-1(b)(4)(i), an allocation of GST tax exemption becomes irrevocable after the due date of the return. However, the Regulations further provide that an allocation of GST tax exemption to a trust is void if the allocation is made with respect to a trust that has no GST potential with respect to the transferor making the allocation, at the time of the allocation. In making this determination, a trust has GST potential even if the possibility of a generation skip is so remote as to be negligible. In this case, the transfers were made outright, and not in trust.

Because the grandchildren's parent was deceased at the time of the transfers, the transfer was not a generation-skipping transfer, and the allocation of GST tax exemption was void.

37. Letter Ruling 201539001 (Issued June 23, 2015; released September 25, 2015)

Section 9100 relief and extension of time granted to allocate GST tax exemption to transfers over many years to a Crummey trust, in which some transfers were deemed allocations, and some transfers were not

The taxpayers established an irrevocable trust for the benefit of a beneficiary and the beneficiary's descendants. The beneficiary was granted a withdrawal right, which was noncumulative and lapsed if not exercised. The withdrawal right was not limited under Section 2514(e), that is, the gift did not lapse to the extent of the greater of $5,000 or 5 percent of the trust assets. In certain years, the amount transferred to the trust was in excess of the limits under Section 2514(e). The taxpayers made transfers to the trust in years 1 through 14.

Following the death of the taxpayers and the beneficiary, it was discovered that the taxpayers and the beneficiary had failed to allocate GST exemption to the trust. The executor of the estates of the taxpayers requested relief under Treas. Reg. § 301.9100-3 and an extension of time to allocate each taxpayer's available GST tax exemption to the transfers to the trust, effective as of the date of each transfer.

The IRS ruled that the taxpayers were the transferors for GST tax purposes of one-half each of the transfers made to the trust in years 1 through 14. Further, the beneficiary was the transferor for GST tax purposes to the extent that a transfer in a given year exceeded the limits in Section 2514(e). Thus, the trust had three separate transferors for purposes of GST tax.

Beginning in 2001, transfers to the trust were subject to the automatic exemption rules of Section 2632. Accordingly, for transfers by the taxpayers made in 2001 and following, GST tax was automatically allocated to those transfers. As for transfers made before 2001, the executors were granted relief under Treas. Reg. § 301.9100-3 to allocate GST tax exemption to the transfers, as of the value on the date of such transfer.

38. Letter Ruling 201607022 (Issued October 29, 2015; released February 12, 2016); Letter Ruling 201607023 (Issued October 29, 2015; released February 12, 2016)

Taxpayer was given an extension of time to allocate GST exemption

Taxpayer and spouse established a trust prior to December 31, 2000, when the automatic allocation of GST exemption rules became effective. Transfers were made to the trust for four years prior to 2001 and for four years starting in 2001. The value of the transfers to the trust did not exceed the gift tax annual exclusion for each of the years in which the gifts were made. Taxpayer and spouse retained an accountant to provide tax and accounting services in each of the years. The accountant failed to prepare the forms to report the transfers and to allocate GST exemption. Taxpayer and spouse had sufficient GST exemption to be allocated to the transfers for the trust in each of the years under review. Taxpayer requested an extension of time to allocate GST exemption to the transfers made for the years prior to 2001 (when the automatic allocation rules became effective) and a ruling that the automatic allocation rules applied to the transfers made to the trust in the years from 2001 onward.

Requests for relief under Treas. Reg. § 301.9100-3 will be granted when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that granting the relief sought by the taxpayer will not prejudice the interest of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election. The Service found that the requirements of Treas. Reg. § 301.9100-3 had been satisfied. The taxpayer was granted an extension of time to make the allocations of GST exemption to the trust for transfers made prior to 2001. The Service also ruled that GST exemption was automatically allocated to the transfers for the years starting in 2001.

39. Letter Rulings 201615005 and 201615006 (Issued December 31, 2015; Released April 8, 2016)

Service permits an extension of time to allocate GST exemption

Each of these two letter rulings deals with a situation in which the taxpayer and spouse created an irrevocable trust that had potential exposure to GST tax. Gift tax returns were filed to report the gift and to treat the gifts as made one half each by taxpayer and spouse. On their returns, taxpayer and spouse each allocated a specific amount of GST exemption but failed to include a notice of allocation on his or her gift tax return and to sign his or her respective return. An accountant prepared the returns and advised the taxpayer and spouse to affirmatively allocate GST exemption to the transfers. The transfers were later discovered.

Request for relief under Section 301.9100-3 will be granted when the taxpayer can show that the taxpayer acted reasonably in good faith and that granting relief would not prejudice the release of the government. Treas. Reg. § 301.9100-3(b)(1)(v) provides that taxpayer is deemed to have acted reasonably and in good faith if a taxpayer relied on a qualified tax professional. The Service concluded that the requirements of Treas. Reg. § 301.9100-3 had been satisfied and an extension of time to allocate GST exemption was permitted.

40. Letter Ruling 201543006 (Issued June 24, 2015; released October 23, 2015)

Division and modification of trust will not affect generation-skipping transfer tax, provided court approves of modification

Under the facts of this letter ruling, a testamentary trust was established under the will of the testator. The primary beneficiary of the trust was the testator's son, and the son's descendants were also beneficiaries of the trust. The testator died before September 25, 1985, and thus the trust was grandfathered from application of the generation-skipping transfer tax. The son currently has 4 living children.

Under the terms of the trust, the trustee may distribute income and principal to the son and his descendants in the trustee's absolute discretion. The trustee also has discretion to distribute undistributed income to a charitable foundation. The trust states the testator's intent that the trustee distribute such income to the charitable foundation, so long as such a distribution does not interfere with the security of the testator's descendants. At the son's death, the remaining income and principal of the trust is to be distributed to the son's then living descendants, *per stirpes*, with each share held in a separate trust for the benefit of such descendant. The trust is subject to the common-law Rule Against Perpetuities—that is, the trust is to terminate one day before the date that is 21 years after the date of death of the last to survive of the testator's descendants who were living at the testator's death. At the termination date, the remaining assets of each trust are to be distributed to the foundation.

During the administration of the trust, the needs and investment goals of the grandchildren have been different. The trustee wished to divide the trust into separate trusts, one for each grandchild, with the dispositive terms otherwise identical to the current trust, with each trust to exist for the benefit of the son and a particular grandchild, and with each trust having the same termination date as the original trust.

The trustee plans to submit a petition to the court for this modification. State law allows such a modification upon petition of a trustee or beneficiary, if because of circumstances not known to or anticipated by the settlor, the order will further the purposes of the trust, or modification of administrative, nondispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust's administration.

The IRS ruled that, so long as the court approved of the modification, the modification would not cause the trusts to be subject to GST tax. In addition, the IRS ruled that because the beneficiaries will have substantially the same beneficial interests, rights, and expectancies after the proposed division of the trust, such a modification would not trigger gift tax.

41. Letter Ruling 201544005 (Issued June 19, 2015; released October 30, 2015)

Reformation of trust removes reversionary interest, provides for completed gifts, and provides that assets will pass outside of settlor's estate

In this ruling, a husband and wife created a trust for the benefit of their two children. The terms of the trust provide that it is irrevocable. The trust provides for certain distributions to the grantors' children for their "well-being," with an emphasis on the children's education, health, and personal development. The trust provides that if all of the grantors' children are deceased, the assets revert back to the grantors. The grantors were the trustees of the trust, but the grantors never made any distributions to the beneficiaries.

The grantors filed a gift tax return for contributions to the trust, but they later became concerned that the assets to the trust would not be treated as completed gifts, and the assets of the trust could be included in the grantors' estates for estate tax purposes.

In state court proceedings, the grantors and the drafting attorney submitted evidence that the grantors intended that transfers to the trust be completed gifts for gift tax purposes, and that the assets of the trust be outside of the grantors' estates for estate tax purposes, and that the potential inclusion of the assets in the grantors' estates was caused by scrivener's errors. The trust was reformed to correct these scrivener's errors, to provide that distributions to the beneficiaries are subject to an ascertainable standard, and to provide that in the case of a deceased child, the assets would pass to the child's estate rather than to the grantors. The grantors resigned as trustees.

Citing Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the IRS noted that when the issue involves the determination of property interests for federal tax purposes, the determination is based on state law based on the highest court of the state, giving "proper regard" to the lower court's determination. The IRS reviewed the reformations to correct these scrivener's errors, and determined that these reformations were consistent with state law as applied by the highest court of the state. Accordingly, the modifications to the trust would be retroactive to the creation of the trust for federal tax purposes, such that the original transfers to the trust would be completed gifts for gift tax purposes, and the assets would pass outside of the estate of the grantors for estate tax purposes.

42. Letter Ruling 201606002 (Issued October 13, 2015; released February 5, 2016)

Termination of GST grandfathered trust will not have adverse generation-skipping tax consequences

Grantor established a trust prior to September 25, 1985. As a result, the trust was grandfathered from the generation-skipping tax. The trust provided that separate trusts would be established for the children and a step child of the grantor. Each trust provided that after a child reached age 21, the trustees were to pay the net income of the trust to the child. However, the trustees could withhold so much of the income of the trust as the trustees determined not to be required for the support, comfort, education, and welfare, or for any other purpose the trustees believed to be in

the child's best interest. Any withheld income could be paid to descendants of the child. In addition discretionary principal distributions could be made to the child if income was not sufficient. At the death of the child, the child was given limited power of appointment to the child's spouse and to descendants. In default of exercise of the limited power of appointment, separate trusts were to be created for each grandchild of the child.

Child One died without a surviving spouse or living descendants. Child One did not exercise her special power of appointment over the assets of the trust. The trust was silent as to the distribution provisions if Child One died with no surviving spouse or descendants. After two years of discussions, all interested parties entered into a settlement agreement that was contingent upon approval by the state court and the receipt of a favorable private letter ruling from the Internal Revenue Service that distribution of the assets pursuant to the terms of the settlement agreement would not result in generation-skipping tax. Treas. Reg. 26.2601-1(b)(4)(B) provides that a court approved settlement of a bona fide issue regarding the administration of a trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to GST tax if the settlement is the product of arm's length negotiations and the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement.

Based upon the facts provided including the lack of provisions in the trust setting forth the distributions to be made in the event that the child had no spouse or descendants, the representation of all the parties by separate counsel, and the applicable provisions of state law, the IRS found that the requirements of Treas. Reg. § 26.2601-1(b)(4)(i)(B) were satisfied and ruled that the termination of the trust and distribution of the assets of the trust pursuant to the terms of the settlement agreement would not result in GST tax.

FIDUCIARY INCOME TAX

43. Belmont v. Commissioner, 144 T.C. No. 6 (2015)

Estate is not entitled to income tax deduction under Section 642(c)(2)

Decedent's will directed that the residue of her estate, which included income in respect to the decedent, be left to charity. The estate took a charitable contribution deduction under Section 642(c)(2) on its federal income tax return claiming that it had permanently set aside an amount of its gross income for charity.

At the time of her death, Decedent owned a condominium in which her brother resided. During the protract administration of the estate, the brother took a variety of legal actions and asserted a life tenancy interest in the condominium. The brother was subsequently awarded a life tenancy in the condominium. Because of the cost of litigation over the condominium, the estate lacked sufficient funds to pay the amount previously deducted as a charitable contribution.

The court found that under Section 642(c)(2), any part of the gross income of an estate which pursuant to the terms of the governing instrument is permanently set aside during the taxable year for charitable purposes shall be allowed as an income tax deduction to the estate on the fiduciary income tax return.

Treas. Reg. § 1.642(c)-2(d) provides that no amount will be considered permanently set aside for charity unless under the terms of the governing instrument and the circumstances of a particular case, the possibility that the amount set aside will not be devoted to such purpose or use is so remote as to be negligible. The possibility that the costs involved in a dispute over the condominium would cause the estate to invade the amount set aside for charity was not "so remote as to be negligible" as required under the regulations. As a result, the estate did not "permanently set aside" the charitable contribution amount as required under Section 642(c)(2) and, therefore, was not entitled to the income tax charitable deduction.

44. Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue, No. COA15-896 (N.C. Ct. App., July 5, 2016)

North Carolina Court of Appeals holds statute taxing trust income unconstitutional

The North Carolina Court of Appeals upheld a lower court decision on whether a New York trust was subject to North Carolina state income tax. The Business Court held that the application of North Carolina General Statute Section 105-160.2 was unconstitutional as applied to the Kimberly Rice Kaestner 1992 family trust and ordered the refund of state income taxes for which the trust had applied. The opinion issued by the Business Court noted that the trust has no connections to North Carolina other than the residence of the beneficiary, which was insufficient to satisfy either the Due Process or Commerce clause of the U.S. Constitution to support state taxation of the trust. In its July 5, 2016, decision, the Court of Appeals agreed with the Business Court, but analyzed the constitutionality of the statute, as applied to the trust, solely under the Due Process Clause.

Applying the minimum contacts requirement of the Due Process Clause, the Court of Appeals looked to the decisions of Quill Corp. v. North Dakota, 504 U.S. 298 (1992), and International Shoe Co. v. Washington, 326 U.S. 310 (1945), that "it is essential in each case that there be some act by which the [party] purposefully avails itself of the privilege of conducting activities within the forum State." The Court of Appeals found that the trust did not maintain any physical presence in North Carolina, never held assets located in North Carolina, did not keep records in North Carolina, and could not otherwise be said to have a physical presence in North Carolina. The only connection between the trust and North Carolina is the residence of the beneficiary.

In its brief, the Department of Revenue cited Court decisions from California and Connecticut to support a finding that basing taxation of the trust on the state of domicile of the beneficiary is constitutional. The Court of Appeals rejected the Department of Revenue's argument, siding with the taxpayer. The taxpayer's position is that a trust and beneficiary are separate legal entities for tax purposes, and therefore, the residence of the beneficiary (alone) should not form the basis by which a trust is subject to income tax. In agreeing with the taxpayer's position, the Court of Appeals not only noted the decision of the Supreme Court in Brooke v. Norfolk, 277 U.S. 27 (1928), but found it controlling.

In Brooke, the taxpayer, a trust created by a resident of Maryland and administered by a trustee located in Maryland, appealed the assessment of taxes (in that case, ad valorem taxes) by the state of Virginia on the basis that the trust beneficiary was a resident of Virginia. In finding the assessment of tax on the trust in Brooke unconstitutional, the Supreme Court found that "the

[trust] property is not within the state, does not belong to the [trust beneficiary] and is not within her possession or control. The assessment is a bare proposition to make the [trust beneficiary] pay upon an interest to which she is a stranger."

Finding that the application of the statute to the trust did not satisfy the requirements of the Due Process Clause, the Court of Appeals declined to consider the application of the Commerce Clause.

With the affirmation of the Business Court decision by the Court of Appeals, the North Carolina Department of Revenue likely will seek further review by the North Carolina Supreme Court. Additionally, the North Carolina legislature has considered an amendment to the statute that would provide for the taxation of a trust administered in North Carolina to the extent that the beneficiaries of the trust are resident in North Carolina. As for trusts with resident beneficiaries that have been subjected to North Carolina income taxation, application for a refund may be considered where the only nexus to North Carolina is the residency of a beneficiary.

45. 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), affirming 27 N.J. Tax 68 (N.J. Tax Ct. 2013)

Trust not subject to New Jersey income tax

Trust A was created by the will of a New Jersey resident who died in 1998. New Jersey law defines a resident trust for income tax purposes to include "a trust, or a portion of a trust, consisting of property transferred by the will of a decedent who at his death was domiciled in this state." This case dealt with income received in 2006. During that tax year, the sole trustee resided in New York and administered the trust outside of New Jersey. The trustee filed a return and paid New Jersey tax on Subchapter S corporation income attributable to activity in New Jersey. However, the trustee did not file a return and pay New Jersey tax on interest income and S corporation income allocated to activities outside New Jersey. The New Jersey Division of Taxation contended that the trustee was taxable on all undistributed income because the trust held assets in New Jersey.

The New Jersey Tax Court granted the taxpayer's motion for summary judgment. It rejected the Division of Taxation's arguments that the trust should be subject to taxation because the return showed the tax preparer's New Jersey address rather than the trustee's New York address. The court also rejected the director's assertion that the lack of a presence in New Jersey could be overcome by the United States Supreme Court's ruling in Quill Corporation vs. North Dakota, 504 U.S. 298 (1992). It noted that Quill involved a plaintiff actively conducting a mail order business that targeted residents of North Dakota, while the trust at issue in this case carried out business directly as a passive owner of stock. It also distinguished Quill in that Quill involved the imposition of use tax, and the present case involved the imposition of income tax. The New Jersey Tax Court held that Trust A cannot be deemed to own assets in New Jersey merely because it was a shareholder in S corporations that own New Jersey assets.

The Appellant Division affirmed the New Jersey Tax Court. It did so using the New Jersey square corners doctrine that requires the government to deal fairly with its citizens and engage in

equitable practices. It noted that the Division of Taxation's official guidance gave taxpayers unequivocal advice that undistributed trust income would not be taxable if the trustee was not a New Jersey resident and the trust had no New Jersey assets. In fact, the argument that a trust was subject to taxation of its retained income if it had any New Jersey income was only announced in 2011. The court noted that it was fundamentally unfair for the Division of Taxation to announce in its official publication that under a certain set of facts a trust's income will not be taxed, and then retroactively apply a different standard years later.

46. Webber v. Commissioner, 144 T.C. No. 17 (June 30, 2015)

De facto control over investment assets of trust has adverse income tax consequences to creator

Webber is a case involving investor control. In this case, Jeffrey T. Webber, a venture capital investor and private equity fund manager, as part of his estate planning, created first an Alaskan grantor trust that bought "Flexible Premium Restricted Lifetime Benefit Variable Life Insurance Policies" on the lives of his aunt and step-grandmother-in-law from a Cayman Islands Insurance Company. The Alaskan trust was held for the benefit of Webber and his descendants, with a corporate trustee with "uncontrolled discretion" to distribute trust assets to the beneficiaries, and with Webber's attorney (in the U.S.) as trust protector. Subsequently, the policies were transferred to a Bahamian foreign grantor trust which was the nominal owner of the policies during the tax years in question. Later, the policies were transferred to a Delaware grantor trust. The terms of each of the Bahamian and Delaware trusts were materially the same as the Alaskan trust.

The policies stated that Webber had no power to direct investments. But the investment manager always followed Webber's investment directions. Nearly all of the investments were non-publicly traded securities, and Webber admitted that the investment manager could not have had access to these investments except through him. In many cases, Webber negotiated a deal directly with a third party, then "recommended" that the investment manager implement the deal that he had already negotiated. "In reality," as the Tax Court put it, "the Investment Manager selected no investments but acted merely as a rubber stamp for petitioner's 'recommendations,' which we find to have been equivalent to directives." Webber was taxed on the income from the policies' investments, under the "investor control" doctrine. The investor control doctrine provides that, if the policyholder's incidents of ownership over the investment assets in the separate account in the insurance policy become sufficiently capacious and comprehensive, the policyholder rather than the insurance company is deemed to be the true owner of the assets for federal income tax purposes and, as a result, the deferral or elimination of the tax on the inside buildup will be lost and the investor will be taxed currently on the investment income as it is realized.

In the most basic of income tax analysis, the court pointed out that Section 1 of the Internal Revenue Code imposes a tax on the taxable income "of" every individual and quoted the Supreme Court's elaboration that "[t]he use of the word 'of' denotes ownership." Poe v. Seaborn, 282 U.S. 101, 109 (1930). As to "ownership," again quoting the Supreme Court, "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed – the actual benefit for which the tax is paid." Corliss v. Bowers, 281

U.S. 376, 378 (1930). The "investor control doctrine" is derived from Revenue Rulings 77-85 (1977-1 C.B. 12), 80-274 (1980-2 C.B. 27), 81-225 (1981-2 C.B. 12), 82-54 (1982-1 C.B. 11), and 2003-91 (2003-2 C.B. 347), all addressing life insurance policies and annuity contracts sold by life insurance companies. Making an important jurisprudential point that might apply in other contexts, the court noted that it was not bound by these revenue rulings, but that under Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944), they may be given weight on the basis of "their persuasiveness and … consistency" over 38 years.

The outcome in Webber, based on *de facto* control despite the governing trust documents, is reminiscent of SEC v. Wyly, 56 F. Supp.3d 394 (S.D.N.Y. 2014), in which the indirect control exercised by the grantors through the trust protectors of what were supposed to be foreign nongrantor trusts caused the trusts to be grantor trusts for federal income tax purposes with the grantors being subject to tax on all the income.

As wealth becomes more concentrated – or at least as increases in the federal estate tax exemption focus estate planning more on the very wealthy – the hazard of talented and strong-willed individuals' seeking to maintain control even after making gifts may be encountered more frequently. In other words, the less the control retained by the grantor, the more likely that the desired tax results will be obtained in many complex tax strategies.

47. Green v. United States, 116 AFTR 2d 2015-6668 (W.D. Okla. Nov. 4, 2015)

Trust allowed charitable income deduction for fair market value of and not basis in appreciated real estate to charity

This case may simplify and enhance the charitable contribution deduction for certain contributions of appreciated property by trusts. Green involved charitable donations of appreciated real estate in 2004 by The David and Barbara Green 1993 Dynasty Trust, which owned a 99 percent limited partnership interest in Hob-Lob Limited Partnership, which in turn owned or operated many Hobby Lobby stores. The trust deducted the adjusted basis of the properties on its 2004 federal income return and then amended the return exactly three years later to deduct the full fair market value of the properties. The IRS disallowed the refund, stating, a bit simplistically, that "[t]he charitable contribution deduction for the real property donated in 2004 is limited to the basis of the real property contributed."

The District Court granted summary judgment to the trust. Citing opinions of other courts, it stated that "[t]he purpose of Congress in enacting [charitable contribution provisions] was to encourage charitable gifts" and that "statutes regarding charitable deductions … are not matters of legislative grace, but rather 'expression[s] of public policy.'" As such, "[p]rovisions regarding charitable deductions should … be liberally construed in favor of the taxpayer." The Government argued that Section 642(c) limits the deduction to "any amount of the gross income … paid." The court was persuaded by the fact that the properties had been bought with gross income. The Government also argued that gross income does not include unrealized appreciation, but the court found no limitation to basis in Section 642(c).

48. Green v. United States, __ F. Supp. 3d. __ (W.D.Ok. 2016)

Trust can claim an income tax charitable contribution deduction for a cash contribution despite the wrong entity originally making the contribution and having the contribution credited to it

David M. Green, Barbara A. Green, and Mark D. Green created the 1993 Dynasty Trust. The dynasty trust expressly authorized the trustee to distribute such amounts from the gross income of the dynasty trust as the trustee determined to be appropriate. This specifically included distributions to charity. Between 2002 and 2004, Hob-Lob LP owned or operated many, but not all, Hobby Lobby stores. During the same period, the dynasty trust was a 99 percent limited partner in Hob-Lob LP. Hob-Lob LP, when it filed its yearly income tax return with the IRS, issued a Schedule K-1 to each of its partners including the dynasty trust.

In 2004, Hob-Lob LP donated $1,870,204.46 to Reach the Children Foundation. Hob-Lob LP was allowed a 99 percent deduction for its cash payments to Reach the Children Foundation. In 2004, Hobby Lobby donated $4.7 million in cash to Reach the Children Foundation and Book of Hope. The trustee of the dynasty trust stated that, although the contribution of $4.7 million was inadvertently issued by Hobby Lobby, the donation was actually made by Hob-Lob LP and was properly accounted for on Hob-Lob LP's audited 2004 financial statements. The mistake apparently occurred because Hob-Lob LP and Hobby Lobby had a shared accounting system.

In 2005, the dynasty trust filed its Form 1041 for the tax year 2004 claiming a charitable deduction totaling $20,526,383. After the discovery and correction of the inadvertent issuance of the $4.7 million donation by Hobby Lobby to Reach the Children and Book of Hope, the dynasty trust then filed an amended Form 1041 increasing its reported charitable deduction to $29,654,233 and claiming a tax refund of $3,194,748.

The IRS disallowed the refund and moved for summary judgment. The IRS contended that deductions cannot be exchanged or sold or otherwise distributed among taxpayers. The court noted that a charitable contribution was at issue. Although the contribution was originally issued on Hobby Lobby checks, the subject contribution was ultimately borne by Hob-Lob LP. Once discovered, the clerical error was thoroughly addressed. Letters of correction were sent, affidavits were signed, books were corrected, and Hob-Lob LP reimbursed Hobby Lobby's account for the full amount of the contribution. It noted that the dynasty trust was seeking relief in accordance with Hob-Lob's correct financial statements that reflected the actual contributions made by Hob-Lob LP. To disallow a charitable deduction simply because of a clerical error went against the liberal policy of encouraging charitable giving. As a result, the court denied the IRS's motion for summary judgment.

OTHER ITEMS OF INTEREST

49. West Virginia Senate Bill 493 (Passed March 10, 2016 and Approved by Governor on March 23, 2016)

West Virginia enacts domestic asset protection trust legislation

On March 10, 2016, the West Virginia legislature passed legislation permitting domestic asset protection trusts that provide grantors with spendthrift protection from creditors if certain requirements are met. The governor approved the legislation on March 23, 2016. It will become effective ninety days after passage on June 10, 2016. West Virginia becomes the seventeenth state with some form of legislation that permits creditor protection for self-settled trusts.

The West Virginia domestic asset protection trust legislation is found in West Virginia Code Sections 44D-5-503a et seq. The rules for West Virginia domestic asset protection trusts are similar to the laws in other states. The trust must be irrevocable and created during the grantor's lifetime. There must be a West Virginia trustee. Some of the assets of the trust must be maintained in West Virginia, records for the trust must be maintained within West Virginia on an exclusive or non-exclusive basis, and the preparation of income tax returns must be arranged for or occur in West Virginia or the West Virginia trustee must materially participate in some other way in the administration of the trust.

The grantor may only be entitled to discretionary distributions of income and principal. There must be at least one beneficiary other than the grantor. The trust must provide that West Virginia law applies to the validity, construction, and administration of the trust. The trust must contain a spendthrift provision. The grantor cannot retain the right to disapprove distributions from the trust but can retain a limited testamentary power of appointment.

The grantor must provide a qualified affidavit stating that:

1. The property transferred to the trust was not derived from unlawful activities;

2. The grantor has full power to transfer the property to the trust;

3. The grantor will not be rendered insolvent by the transfer of the property to the trust;

4. There is no intention to defraud any creditor;

5. There are no pending court actions against the grantor except those specifically identified in an attachment to the affidavit;

6. The grantor is not engaged in any administrative proceedings except those specifically identified;

7. The grantor does not owe alimony or child support.

Creditors have a four year period after a transfer to the trust to bring an action to challenge the transfer. No creditor or any other person has a claim against the trustee, trust adviser, trust director, or any other person involved in counselling, drafting, preparing, or executing the trust.

50. Letter Ruling 201614003 (Issued December 18, 2016; released April 1, 2016)

Trust is a Qualified Subchapter S Trust after nonjudicial settlement under state law

Only three types of trusts qualify as shareholders of an S Corporation. The first is a grantor trust for income tax purposes, the second is an Electing Small Business Trust under Section 1361(e), and the third is a Qualified Subchapter S Trust. This letter ruling involved the effect of a nonjudicial settlement agreement to change the terms of a trust so that the trust met the requirements of a Qualified Subchapter S Trust.

Parent created a trust for the benefit of his child who was a citizen of the United States. The trust provided that the income from the trust was to be paid at least quarterly to the child until the complete distribution of the trust or the child's death. The trustee could also pay principal for the health, maintenance in reasonable comfort, education (including postgraduate) and best interests of the child and his descendants, individually and as a group, considering all the sources of income for each of them. The trust also provided that the child must be the primary beneficiary of the trust and that the trustee could disregard the interests of the remaindermen of the trust in the investment of the trust assets. The trust did not qualify as a Qualified Subchapter S Trust under Section 1361(d)(3) since the child was not the only beneficiary of the trust while the child was alive. Section 1361(d)(3) defines a as a trust in which the income is distributed or required to be distributed to one individual and any corpus distributed during the life of the current income beneficiary may only be distributed to that income beneficiary.

Under the governing state law, interested parties may enter into a non-judicial settlement agreement with respect to the validity, interpretation, and construction of the terms of trust that is final and binding on the trustee and all current and future beneficiaries of the trust. The trustee and the beneficiaries of the trust entered into a non-judicial settlement agreement under which the power of the trustee to distribute the principal of the trust would be limited to the child during the child's life. As a result, the trust met the requirements of Qualified Subchapter S Trust.

51. <u>Billhartz v. Commissioner</u>, 2015 U.S. App. LEXIS 12730 (7th Cir. 2015)

Tax Court did not abuse discretion for refusing to vacate settlement between the Internal Revenue Service and estate

Warren Billhartz had four children from his first marriage, which had ended in divorce. Under the marital settlement agreement, Billhartz agreed to leave an amount equal to one-half of his estate to his four children. Billhartz subsequently remarried and remained married until his death in 2006. At his death, virtually all of his assets were either held in a trust or in joint tenancy with his second wife. The trust named his second wife and one of his four children as co-trustees. Under the terms of the trust, the trustee was to set aside an amount sufficient to purchase an

annuity that would pay his first wife an annuity of $3,000 monthly. From the remaining funds, 6% was left to each of his three daughters and 16% was left to his son.

Although the marital settlement agreement provided that the four children were to receive 50% of Billhartz's estate (an undefined term), divided evenly, they cumulatively ended up with less than 34% of Billhartz's assets divided unevenly. The children executed an agreement (the "Waiver Agreement") in which they accepted the lesser share set out for them in the trust and waived all potential claims that they might have been able to assert. The payments to the children totaled approximately $20 million. Each daughter received about $3.5 million and the son received $9.5 million. On the federal estate tax return, the estate claimed a deduction of approximately $14 million for the amounts passing to the children (equal to $3.5 million dollars per child even though the son received more). The estate claimed the deduction as a claim against the estate under Section 2053. According to the estate, the amounts paid to the children were paid in settlement of a debt owed to them by Billhartz pursuant to his contractual obligations of the marital settlement agreement.

The IRS disallowed the full $14 million deduction. After discussion and negotiation, the estate and the IRS settled before going to trial in the Tax Court. Under the settlement, the IRS agreed to concede 52.5% of the original $14 million deduction. The Tax Court was notified of the settlement and the trial was removed from the docket. The court ordered the parties to submit a decision document reflecting the terms of the settlement by July 24, 2012. On June 12, 2012, the daughters filed lawsuits in state court against the estate contending that the Waiver Agreement had been procured by fraud. In addition, the son, after resigning as co-trustee, filed a similar lawsuit. As a result of the state court lawsuits, the estate asked the tax court for an extension of time to submit the decision document. The court granted a 90-day extension period. On October 1, 2012, the estate moved to restore the case to general docket arguing that it should be entitled to deductions under Section 2053 for the additional payment arising from the state court litigation, and therefore the settlement amount would have to be recalculated in the event of additional payments. The IRS moved for entry of a decision consistent with the terms of the settlement agreement. While the motions were pending in the Tax Court, the estate settled with the children in their state court lawsuits and the estate agreed to pay each of the daughters an additional $1.45 million.

On June 14, 2013, the Tax Court denied the estate's motion to restore the case to the general docket and granted the IRS's motion for entry of a decision. The estate requested the Seventh Circuit to review the decision of the Tax Court. The Seventh Circuit held that the Tax Court did not abuse its discretion by refusing to set aside the settlement. The Seventh Circuit rejected the two arguments that the estate made to set aside the settlement. The first was the doctrine of mutual mistake. The estate argued that the parties' belief that the estate's debt to the children had been finally determined by the Waiver Agreement was a basic factual assumption underlying the settlement with the IRS. The Seventh Circuit noted that it had difficulty seeing how the finality of the estate's payments to the children could have been a basic factual assumption when the $14 million amount that the estate wished to deduct differed from the $20 million amount that the estate agreed to pay the children in the Waiver Agreement. In addition, the rules governing rescission for either mutual or singular mistakes are inappropriate when a party's erroneous prediction or judgment about future events is involved.

The estate's second argument was that the IRS made a misrepresentation during settlement negotiations by knowingly omitting a material fact, specifically that the children might initiate a new lawsuit against the estate. The Seventh Circuit noted that the estate was in a much better position than the IRS to anticipate the children's litigation. This meant that the IRS's admission likely would not have changed the estate's views regarding the likelihood of a lawsuit. As a result, the decision of the Tax Court was upheld.

52. United States v. Sadler, 2015 U.S. Dist. LEXIS 100829 (E.D. Pa. 2015)

Estate liable for income tax debts of decedent

Robert L. Sadler died in 2009. In 2013, the Internal Revenue Service sued Sadler's estate to recover an outstanding tax liability of $42,912.66 at the time the complaint was filed. Sadler had deficiencies in income taxes going back to 1994. The IRS also determined that Sadler had understated his tax liability for 2001 and 2002 by taking deductions for expenses allegedly incurred complying with the American with Disabilities Act and for other transactions that lacked economic substance. The parties filed motions for summary judgment. The IRS sought to reduce to judgment the entire amount that it alleged was owed. The defendant in its motion for summary judgment did not dispute the underlying tax liability but alleged that it should be abated for technical reasons relating to the application of overpayments from the 2001 and 2002 taxes to taxes in 1994.

The court granted summary judgment to the IRS. It noted that the IRS properly applied claimed overpayments in 2001 and 2002 as credits towards outstanding tax liability from 1994 and was now entitled to recover the entire amount of tax assessed in 2001 and 2002 from the estate.

53. West v. Koskinen, No. 1:15-cv-00131 (E.D. Va. October 19, 2015)

Estate was liable for more than $335,000 in penalties and interest for failing to timely pay estate taxes

The IRS assessed $317,821.05 in interest and penalties against an estate for failure to timely pay estate taxes. The executors sought a refund, on the grounds that they reasonably relied on erroneous advice of counsel regarding the timing of filing of the estate tax return and payment of estate taxes.

At issue was an email from the decedent's attorney, in response to questions from the executors regarding legal steps required for the estate "in the short term". The attorney wrote in pertinent part, "[the executors would] need to pay … final bills, and … possibly file a Federal Estate tax return, [the decedent's] final 1040, and a trust income tax return," and that "[t]his all takes as short as a few months or (if an estate tax return is required) as long as [two] years." The next day, one of the executors responded that he was "sure there will be tax due" and that he "assume[d]" that the accountant who had handled the decedent's taxes would prepare the estate tax return. During a later meeting with the attorney, estate taxes were not discussed. After the deadline for the estate tax return had passed, the attorney was asked to begin work on the estate tax return, and the attorney assumed that the accountant had filed for an extension. The attorney

filed the estate tax return and submitted tax of $1,258,019. The IRS responded that because the estate tax return was filed late, penalties and interest were due in the amount of $335,636.76.

The court summarized that the IRS can assess a tax penalty unless such failure is due to "reasonable cause". The court summarized that this "reasonable cause" requires at least the exercise of ordinary business care and prudence, and an inability to file by the deadline or to pay the tax. The court concluded that "[n]o reasonable person exercising ordinary business care and prudence would rely on the email for [the] purpose [of estate tax filing or payment deadlines," and thus the taxpayers had failed to satisfy this requirement. The court thus upheld the penalties and interest.

54. United States v. Randy Read, ___ F. Supp. 3d ___ (D. Conn. 2016)

Trustee was liable for unpaid taxes after rendering a trust insolvent when he knew that the trust had an unpaid tax liability

Read established a trust in 1999 for the benefit of his children and funded the trust with stock options earned by his wife. In 1999, the property in the trust was worth $700,000. In 2000, the trust filed a request for an extension of time to file its income tax return. The request showed a tax liability of $121,707. Read was aware of the amount of the tax liability in April 2001.

In April 2001, the assets of the trust were $225,170. On June 29, 2001, the value of the trust assets was $162,869.27. Read subsequently made payments from the trust for home renovations, to send his children to summer camp, and directly to himself.

The government moved for summary judgment and sought $175,042.16 plus interest because Read made payments from an insolvent trust that had an outstanding tax liability. The court granted the government's motion for summary judgment. It noted that Read was trustee of the trust which provided for discretionary distributions of income and principal. Read was the only person to have check signing authority for the trust. Read was aware of the tax liability of the trust and Read rendered the trust insolvent when he transferred $25,000 to himself on July 31, 2001 which reduced the trust assets below the amount of the tax liability.

The court found that Read was liable. A trustee will be liable for distributions "to the extent of the payment for unpaid claims" if a "reasonably prudent person" inquired "as to the existence of the debt owed." The court found that a reasonably prudent person would have inquired into the trust tax liability and whether the trust failure to pay would incur non-payment penalties. As a result, Read was liable for the entire amount of the debt owed by the trust which, by 2011, had increased to $213,220.21. The court also found that Read was liable for prejudgment interest because Read was a self-dealing transferee of some of the trust distributions.

55. <u>Estate of Espinor</u>, __ F. Supp. 3d. __ (E.D. Cal. 2016)

Government granted default judgment against an estate and its co-executors and co-trustees and beneficiaries for the estate's unpaid federal estate tax liability

Cipriano Espinor died on October 13, 2004. After Cipriano's death, co-executors Michael C. Espinor and Toni Espinor Hicks administered the estate informally without court supervision and took actions with respect to the distribution of assets without court approval. Cipriano's will contained a pourover provision directing that the residuary assets were to be transferred into a family trust and distributed in accordance with its terms. Michael and Toni were co-trustees of the family trust. The family trust directed that the trustee was required to set aside sufficient assets to be used to pay federal estate tax, debts, and other obligations and directed the disposition of the remaining assets to the named defendants.

The total value of Cipriano's estate was $5,120,869. The estate filed a Section 6166 election to defer the payment of estate taxes for five years and thereafter to pay the remaining tax liability in ten annual installments on a portion of the estate. In this election, the total estate tax liability was calculated at $1,586,551, of which the estate elected to defer $622,563. The estate and the IRS negotiated agreements to secure the debts and for the IRS to enter liens to assure satisfaction which negotiations occurred over several years after 2006. In 2012, the IRS declared the estate to be in default of the installment agreement and terminated the installment agreement. The IRS subsequently sent a notice and demand for payment. The complaint asserted that various assets were distributed by the co-executors and co-trustees to themselves and others while the installment agreement was in effect. The transfers were described as having been made during a time when the estate lacked sufficient assets to pay its outstanding liabilities.

The court found that the estate was liable for $817,944.66 of unpaid federal estate taxes and that the co-executors and co-trustees distributed property of the estate and the Family Trust prior to fully paying the estate tax liabilities. It then found that the co-executors, the co-trustees, and the other recipients of property were jointly liable under Section 6324(a) for the amounts distributed to them before the estate tax obligation was satisfied.

56. <u>Duckett v. Enomoto</u>, __ F. Supp. 3d. __ (D. Ariz. 2016)

Court grants summary judgment to government on the issue of whether a federal tax lien attached to a delinquent taxpayer's right to funds in a testamentary trust established for him by his late mother

Dr. Dennis Enomoto failed to meet his tax obligations for the years 2007 through 2011. As a result, the IRS assessed $701,000 against Dr. Enomoto. Dr. Enomoto's mother passed away in February 2013. Under the terms of his mother's will, one-third of her estate would be distributed to her son in a trust. Under the terms of the trust, Dr. Enomoto was to receive net income and principal of the trust in the sole discretion of the trustee as may be required for support in the beneficiary's accustomed manner of living, for medical, dental, hospital and nursing expenses, or for reasonable expenses of education, including study at the college and graduate levels. The trust was to terminate if the principal of the trust dropped below $10,000. A trust management

services company was named as trustee. Dr. Enomoto's sister, Nancy Duckett, was named the executor of the estate. .

The IRS sought to levy on the $173,545 that would pass to the trust created for Dr. Enomoto's benefit and the government moved for summary judgment directing that the funds be given to the IRS. Under Section 6321, the federal government may impose a lien on any "property" or "rights to property" belonging to a taxpayer. The court looked at the issue of whether the standard of distributions provided for in Dr. Enomoto's trust represented an ascertainable standard under Arizona law which would permit Dr. Enomoto to control distributions and would be considered a property right under Section 6321 or whether the distribution standard was fully discretionary and therefore distributions could not be controlled by Dr. Enomoto and consequently would not be a property right under Section 6321.

The court issued a decision that was partially favorable to the government and partially favorable to Dr. Enomoto. The court first found that the tax lien attached to the trust. The standard of distribution was an ascertainable standard and the trustee's withholding of distributions under the distribution standards would constitute an abuse of discretion in applying an ascertainable standard. The right to distributions under Arizona law created the necessary "property" or "rights in property" for Section 6321 to apply. However, while that right afforded Dr. Enomoto sufficient control of the trust funds to trigger the attachment of the federal tax lien, it did not, by itself justify enforcement of the lien as to any specific amount. Although Dr. Enomoto's right could be assigned a reasonably accurate dollar value by assessing the taxpayer's current needs and living demands, the IRS had failed to provide evidence of Dr. Enomoto's needs or demands and, therefore, there was no reason to think that the lien extended to all of the trust funds. As the court put it, the IRS had a valid lien, but that did not resolve the practical problem of enforcing the lien. The court held that the IRS would be granted a lien to the extent that the lien attached to Dr. Enomoto's right to the trust funds but would not yet be granted the right to a transfer of any funds to it. The amount subject to recovery remained to be determined.

57. **<u>United States v. Kimball</u>, _____, F. Supp. 3d _____ (D. Me 2016)**

Government's motion to enforce federal tax liens against trust created for benefit of taxpayer's children was denied

In this case, the government sought summary judgment first as to the amount of taxes, penalties and interest that John Kimball owed and second to enforce tax liens for those amounts against a trust of which Kimball was the grantor and previously was the trustee. The court granted the government's motion for summary judgment on the first issue, but denied it on the second issue.

With respect to the second issue, in 1989, Kimball, a Massachusetts resident, established the Kimball Family Realty Trust under Maine law. Kimball was the trustee and his five children were the beneficiaries. The purpose of establishing the family trust was to buy a ski condominium for his children. As the original trustee, Kimball had the power to alter or amend the trust. If the trust was revoked in whole or part, any revoked portion was to go to the children and not to Kimball. At the time that the trust was created, Kimball did not have any tax liability. Kimball and his wife separated in 1991 and Kimball resigned as trustee in 1993. Upon Kimball's resignation as trustee, the trust became irrevocable. Kimball paid the condominium

expenses which were modest. When the beneficiaries were young and without driver's licenses, Kimball drove them to the ski condominium for family vacation time. Kimball either did not use or rarely used the condominium in the absence of the children and he never rented it to others to generate income. Kimball did not visit the ski condominium after 2001.

The government argued that when unpaid taxes are assessed, a federal tax lien attaches to all property and rights to property that the taxpayer then holds or subsequently acquires. It stated that the family trust was holding the ski condominium as Kimball's nominee and that the IRS should be able to enforce its tax liens on the condominium for Kimball's personal tax liabilities. The government did not argue that the creation or funding of the family trust was a fraudulent transfer.

The court noted that there was no direct statutory authority for nominee liens. The court also noted that before Maine enacted Uniform Trust Code, the presumption in Maine was that a trust was irrevocable unless stated otherwise. It noted that while the family trust document stated that the trust was revocable, there were two caveats. The first was that only the original trustee could revoke the trust and the second was that if the trust was revoked, the property went to the beneficiaries. Under no condition could the property revert to Kimball. The court also noted that the Maine Uniform Trust Code, which was adopted in 2005, reversed the presumption of irrevocability. The court could not determine that as a matter of law, after Kimball resigned as trustee in 1993, he had rights in the family trust property that would qualify as "property or rights to property" within the federal tax lien statute against which a lien could be enforced. This was a matter that would have to be determined.

58. Uniform Trust Decanting Act (July 2015)

New Uniform Trust Decanting Act provides model provisions for state decanting statutes

The new Uniform Trust Decanting Act (UTDA) was approved by the National Conference of Commissioners on Uniform State Laws (Uniform Law Commission) at its annual conference in Williamsburg, Virginia, July 10-16, 2015. The Reporter was Susan Bart of Chicago, and the Drafting Committee was chaired by Stan Kent of Colorado Springs, Colorado. The Act generally allows decanting whenever the trustee has discretion to make principal distributions, or even if the trustee does not have such discretion if it is appropriate to decant into a special-needs trust. UTDA imposes no duty to decant, but requires that, if decanting is done, it must be done in accord with fiduciary duties. Decanting requires notice to beneficiaries, but not court approval, although a fiduciary or beneficiary may ask a court to provide instructions or relief. Generally decanting may not add beneficiaries, and it may not increase the trustee's compensation without approval of beneficiaries or a court.

Section 19 of UTDA includes extensive explicit safeguards, called "tax-related limitations," to prevent decanting from jeopardizing any intended beneficial tax characteristics of the trust. The beneficial tax characteristics explicitly addressed are the marital deduction, the charitable deduction, the annual gift tax exclusion, the eligibility of the trust to hold S corporation stock, an inclusion ratio of zero for GST tax purposes, preservation of the use of the trust beneficiary's life expectancy in determining minimum required distributions from a retirement plan or IRA, and

the preservation, creation, or termination of grantor trust status as the circumstances might warrant.

The 2011-2012 Treasury-IRS Priority Guidance Plan included, as item 13 under the heading of Gifts and Estates and Trusts, "Notice on decanting of trusts under §§ 2501 and 2601." This project was new in 2011-2012, but it had been anticipated for some time, at least since the publication at the beginning of 2011 of Rev. Proc. 2011-3, 2011-1 I.R.B. 111, in which new Sections 5.09, 5.16, and 5.17 included decanting among the "areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations or otherwise." Rev. Proc. 2016-3, 2016-1 I.R.B. 126, §§5.01(11), (16) & (17), continues this designation.

On December 20, 2011, the IRS published Notice 2011-101, 2011-52 I.R.B. 932, asking for comments from the public on the tax consequences of decanting transactions. Notice 2011-101 also "encourage[d] the public to suggest a definition for the type of transfer ('decanting') this guidance is intended to address" and encouraged responses to consider the contexts of domestic trusts, the domestication of foreign trusts, and transfers to foreign trusts. The Notice also said that the IRS "generally will continue to issue PLRs with respect to such transfers that do not result in a change to any beneficial interests and do not result in a change in the applicable rule against perpetuities period." There were extensive public comments, and there is no doubt that Treasury and the IRS have continued to study decanting. However, decanting was omitted from the 2012-2013 Plan and has been omitted again from the 2013-2014, 2014-2015, and 2015-2016 Plans.

59. Revised Uniform Fiduciary Access to Digital Assets Act (2015)

Revised version of uniform act on digital assets addresses concerns of internet providers

In January 2012, the Uniform Law Commission authorized the formation of a drafting committee to write model legislation authorizing fiduciaries to access, manage, copy, and delete digital assets. The committee developed a Uniform Fiduciary Access to Digital Assets Act (UFADAA), which the ULC approved at its July 2014 annual meeting in Seattle. Despite introductions and discussions of UFADAA in many states, Delaware is the only state that adopted that version of UFADAA. Indeed, the Delaware legislature had enacted the final draft version of UFADAA even before the July 2014 ULC meeting, and the Governor of Delaware signed it into law later in 2014. In other states, enactment of UFADAA was opposed and effectively blocked by a coalition of internet providers and advocates for personal rights and privacy, in many cases by the use of exaggerated horror stories of the breaches of privacy that UFADAA would allow. Some internet service providers even developed and promoted their own very harsh alternative to UFADAA, the Privacy Expectation Afterlife Choices Act ("PEAC Act," pronounced "peace act").

Renewed informal discussions among members of the ULC committee, internet providers, and privacy advocates resulted in a Revised Uniform Fiduciary Access to Digital Assets Act (RUFADAA), which original internet service provider opponents of UFADAA found acceptable and agreed not to oppose. At its Williamsburg meeting in July 2015, the ULC approved

RUFADAA, which generally allows a fiduciary full access to digital assets other than the *content* of electronic communications (unless the user or the court directs otherwise). RUFADAA also sets forth its own recapitulation of fiduciary duties, so as to reassure, within the corners of the Act, service providers and others who might otherwise not have any reason to know or appreciate the scope and seriousness of those duties and the safeguards of privacy those duties entail. The Reporter for RUFADAA was Professor Naomi Cahn of the George Washington University Law School, and the Drafting Committee was chaired by Suzy Walsh of Hartford, Connecticut.

As RUFADAA catches on among the states, it will behoove estate planners and other advisers to structure estate plans and draft estate planning documents, as well as recommend user actions with respect to service contracts, that will be consistent with RUFADAA and will ensure the orderly transition of necessary access when a user dies or becomes incapacitated or missing.

60. Changes in State Death Taxes in 2014 and 2015

Connecticut, Maine, and New York change their state death taxes

Maine on June 30, 2015, increased its exemption to the federal exemption beginning in 2016. Connecticut on July 10, 2015, capped the amount of Connecticut estate and gift tax at $20 million for both residents and nonresidents effective for decedents dying on or after January 1, 2016. New York on April 1, 2015, clarified the new rate schedule that was enacted in 2014 so that it applies to all decedents dying after April 1, 2015 and modified its three year gift add-back provision so that it would not apply to individuals dying after December 31, 2018.

61. 2016 State Death Tax Chart

Available at:

https://www.mcguirewoods.com/sitecore/content/McGuire-Woods/Home/Client-Resources/Publications/State%20Death%20Tax%20Chart%20redirect.aspx