Southern Arizona Estate Planning Council

Recent Developments in Estate Planning and Estate and Trust Administration

Wednesday, October 17, 2018

4:00 p.m. – 6:00 p.m.

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The McGuireWoods Private Wealth Services Group

These seminar materials are intended to provide the seminar participants with guidance in estate planning and administration. The materials do not constitute, and should not be treated as, legal advice regarding the use of any particular estate planning technique or the tax consequences associated with any such technique. Although every effort has been made to assure the accuracy of these materials, McGuireWoods LLP does not assume responsibility for any individual's reliance on the written information disseminated during the seminar. Each seminar participant should independently verify all statements made in the materials before applying them to a particular fact situation, and should independently determine both the tax and nontax consequences of using any particular estate planning technique before recommending that technique to a client or implementing it on a client's or his or her own behalf.

The McGuireWoods LLP Private Wealth Services Group welcomes your questions or comments about these seminar materials. Please feel free to contact any member of the Group.

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PART A

Confronting the Challenges of Tax Reform:

What Happened to the Certainty of Death and Taxes?[1]

Introduction

On December 22, 2017, President Donald Trump signed into law the tax reform bill, "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018" (H.R. 1). The text of the Act extends nearly 500 pages. This legislation is considered the most significant overhaul of the U.S. tax code since 1986. Generally applying to taxable years beginning on and after January 1, 2018, the changes will have a profound impact on individuals, trusts, estates, and businesses in a variety of ways.

Generally, the new tax law alters individual income taxation, reduces corporate income taxes, and introduces a new form of taxing the earnings from certain pass-through entities. In addition, the law moves the United States toward a modified territorial system that alters the current tax landscape for multinational entities. And as for estate tax, gift tax, and generation-skipping transfer tax, by doubling the applicable exclusion amount to $11,180,000 indexed for inflation through 2025, Congress has reduced the number of estates to which the estate tax will apply annually to a few thousand, increased the ability of individuals to make large lifetime gifts and take advantage of the new exemption, and encouraged individuals to do more creative planning to avoid exposure to the generation-skipping transfer tax.

Summary of Provisions of Tax Act

Estate, Gift, and Generation-Skipping Transfer Taxes

Doubling of the Estate and Gift Tax Basic Exclusion Amount and GST Tax Exemption Amount. The Act temporarily doubles the basic exclusion amount for purposes of the estate and gift taxes and the exemption amount for purposes of the generation-skipping transfer ("GST") tax (the "GST exemption"). Under current law, the basic exclusion amount was scheduled to increase to $5.6 million on January 1, 2018. For decedents dying and gifts made after December 31, 2017 and before January 1, 2026 (the "Covered Years"), the basic exclusion amount now equals $10 million, adjusted for inflation annually for each taxable year after 2011. Because the GST exemption amount equals the basic exclusion amount, a corresponding increase in the GST exemption amount will also apply to generation-skipping transfers made during the Covered Years. On January 1, 2018, the basic exclusion amount and GST exemption amount will both increase to approximately $11.18 million per individual (or $22.36 million for married couples).[2]

[1] Portions of this outline are based on materials prepared by the Tax and Employee Benefits Department of McGuireWoods LLP. Other portions of this outline were prepared by Beth Shapiro Kaufman, Miriam Wogan Henry, and Skip Fox for the ACTEC-ALI-CLE Teleconference on January 11, 2018 entitled "Confronting the Challenges of Tax Reform: What Happened to the Certainty of Death and Taxes?'

[2] Internal Revenue Bulletin: 2018-10 (March 05, 2018).

These figures are approximations, subject to the IRS' official announcement of the actual figures as adjusted for inflation. As noted below, regulations are supposed to be issued to ensure that any exemption used prior to the sunsetting of the increased exemption is not clawed back if a donor who has used all of his or her exemption during life prior to the sunsetting dies after the sunsetting of the increased exemption.

* Internal Revenue Bulletin: 2018-10 (March 05, 2018).

Basic Exclusion Amount and GST Exemption Amount as Adjusted for Inflation			
2017 Amounts for Individuals		**2018 Amounts for Individuals**	
Gift & Estate Tax Basic Exclusion Amount	$5.49M	Gift & Estate Tax Basic Exclusion Amount	$11.18M*
GST Exemption Amount	$5.49M	GST Exemption Amount	$11.18M*

The temporary increase in the basic exclusion amount expires on December 31, 2025. Congress has authorized the Treasury Department to issue guidance addressing the treatment of gifts made during the Covered Years by individuals dying after 2025.

Although the increase in the basic exclusion amount and GST exemption amount will not expire until the end of 2025, individuals with significant wealth should consider making use of the increased amounts in 2018. The increased amounts provide the opportunity to leverage gifts for future generations. Estate-planning techniques that benefit most from the increases include:

- Making gifts to existing or new irrevocable trusts, including generation-skipping trusts where appropriate,
- Leveraging gifts to support the funding of life insurance or existing sales to trusts, and
- Pairing gifts with philanthropy.

The exemption will continue to be indexed for inflation, but will be indexed using the "Chained Consumer Price Index." The Chained CPI is short hand for "Chained Consumer Price Index for All Urban Consumers" and increases more slowly than the "Consumer Price Index for All Urban Consumers" or "CPI-U." Basically, the Chained CPI takes account of substitutions consumers would make in response to rising prices of certain items. For example, if the cost of a certain form of transportation went up, individuals might switch to another kind of transportation. This "substitution" is factored into the Chained CPI. Thus, inflation adjustments of the exemptions from estate, gift, and GST taxes should be smaller in the future than they would have been under prior law.

Changes to Income Taxes for Individuals, Estates, and Trusts

Tax Rates. The Act changes the federal income tax brackets and corresponding tax rates for individuals, trusts, and estates for the Covered Years. The following chart summarizes the differences between the 2018 tax rates and brackets that were scheduled to go into effect before passage of the Act, and the 2018 tax rates and brackets under the Act.

Unmarried Individuals			
Original 2018 Tax Brackets and Rates		**New 2018 Tax Brackets and Rates**	
Not over $9,525	10%	Not over $9,525	10%
Over $9,525 but not over $38,700	15%	Over $9,525 but not over $38,700	12%
Over $38,700 but not over $93,700	25%	Over $38,700 but not over $82,500	22%
Over $93,700 but not over $195,450	28%	Over $82,500 but not over $157,500	24%
Over $195,450 but not over $424,950	33%	Over $157,500 but not over $200,000	32%
Over $424,950 but not over $426,700	35%	Over $200,000 but not over $500,000	35%
Over $426,700	39.6%	Over $500,000	37%

Married Individuals Filing Joint Returns and Surviving Spouses			
Original 2018 Tax Brackets and Rates		**New 2018 Tax Brackets and Rates**	
Not over $19,050	10%	Not over $19,050	10%
Over $19,050 but not over $77,400	15%	Over $19,050 but not over $77,400	12%
Over $77,400 but not over $156,150	25%	Over $77,400 but not over $165,000	22%
Over $156,150 but not over $237,950	28%	Over $165,000 but not over $315,000	24%
Over $237,950 but not over $424,950	33%	Over $315,000 but not over $400,000	32%
Over $424,950 but not over $480,050	35%	Over $400,000 but not over $600,000	35%
Over $480,050	39.6%	Over $600,000	37%

Estates and Trusts			
Original 2018 Tax Brackets and Rates		**New 2018 Tax Brackets and Rates**	
Not over $2,600	15%	Not over $2,550	10%
Over $2,600 but not over $6,100	25%	Over $2,550 but not over $9,150	24%
Over $6,100 but not over $9,300	28%	Over $9,150 but not over $12,500	35%
Over $9,300 but not over $12,700	33%	Over $12,500	37%
Over $12,700	39.6%		

The tax brackets for individuals, estates, and trusts increase each year after 2018 based on the chained consumer price index for all urban consumers ("C-CPI-U"). As noted above, a "chained" CPI takes into account anticipated consumer shifts from products whose prices increase to products whose prices do not increase or increase at a lower rate. The result would generally be smaller inflation adjustments and higher tax levels over the long term.

The brackets and rates introduced under the Act, but not the changes to indexing, sunset on December 31, 2025, in accordance with Senate budget rules. For taxable years beginning after 2025, the brackets and rates revert to the brackets and rates in effect under current law (as adjusted for inflation). The Act does not modify the tax rates for long-term capital gains and qualified dividends. The 3.8 percent net investment income tax remains in place under the Act.

Kiddie Tax. The Kiddie Tax rules now subject the unearned income of children subject to tax at trust income tax rates:

- 10% up to $2,550
- 24% up to $9,150
- 35% up to $12,500
- 37% on excess over $12,500

Modification and Elimination of Deductions and Credits Available to Individuals, Estates, and Trusts. The Act modifies or eliminates many tax deductions and credits previously available to individuals, estates, and trusts. Here are some of the most notable changes to deductions under the Act.

- During the Covered Years, individuals may deduct state, local, and foreign taxes only when incurred in connection with a trade or business. However, an exception permits individuals to deduct up to $10,000 for the aggregate of state and local (but not foreign) property and income taxes whether or not incurred in connection with a trade or business.

- During the Covered Years, the deduction for home mortgage interest is available only for interest paid on the first $750,000 of acquisition indebtedness. However, a grandfathering provision permits taxpayers who entered into mortgages effective before December 15, 2017 to continue deducting interest paid on the first $1,000,000 of acquisition indebtedness for such existing mortgages.

- The Act suspends the deduction for interest paid on home equity indebtedness during the Covered Years (including for existing mortgages).

- During the Covered Years, the Act repeals the so-called "Pease Amendment" which imposed an overall limitation on itemized deductions of 3 percent of income over a threshold amount or 80 percent of all deductions.

- Elimination of the tax deduction for alimony for the paying ex-spouse on new divorce agreements executed after December 31, 2018 while excluding the alimony from the income of the recipient ex-spouse.

Modifications to the Alternative Minimum Tax Exemption Amount. The Act increases substantially the alternative minimum tax ("AMT") exemption amounts for individuals and repeals the corporate AMT, but does not modify generally the AMT applicable to estates and trusts.

The AMT is an alternative tax regime that applies to all taxpayers but primarily affects corporations and high-income individuals. AMT is based on the amount by which the taxpayer's alternative minimum taxable income exceeds the AMT exemption amount. The changes to the AMT exemption amounts under the Act are illustrated below:

AMT Exemption Amounts			
2017 AMT Exemption Amounts for Individuals		**New AMT Exemption Amounts for Individuals**	
Unmarried Individuals	$54,300	Unmarried Individuals	$70,300
Married Individuals Filing Joint Returns	$84,500	Married Individuals Filing Joint Returns	$109,400
Estates and Trusts	$24,100	Estates and Trusts	$24,100

The Act also increases the thresholds at which the AMT exemption begins to phase out, from $160,900 to $1,000,000 for married individuals filing joint returns and from $120,700 to $500,000 for unmarried individuals. The increase in the AMT exemption amounts and phase-out thresholds, combined with the modification to the federal income tax brackets and rates, should reduce considerably the number of individuals who are subject to the AMT.

Fiduciary Income Tax Issues. The restriction or elimination of itemized deductions will affect trusts and estates since trust taxation is based on individual income taxes. Trust expenses that are miscellaneous itemized deductions will no longer be deductible just as they will for individuals. Expenses that are deductible under Section 67(e) should continue to be deductible as costs incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in the trust or estate. Allowed deductions should include items such as trustee fees and attorney's fees. The income tax deduction under Section 691(c) for estate tax paid will remain. However, given the small number of estates owing estate tax (due to the doubling of the exemption), this deduction will provide a benefit for the estates of only the wealthiest decedents.

Permanence of Roth IRA Conversions. Individuals have had the ability to convert a traditional IRA to a Roth IRA since 1998 if they paid the income tax on the conversion. Initially, only individuals with adjusted gross income under $100,000 could do a conversion from a traditional IRA to a Roth IRA. This cap was removed for 2010 and later. Individuals doing a conversion could reverse the conversion until the extended due date of the individuals' tax returns for the conversion year. The Tax Act eliminates the ability to reverse course and undo a conversion starting in 2018.

Impact of Tax Act on Businesses and Their Owners

Taxation on U.S. Businesses.

Corporate Income Tax and Corporate AMT. The Act provides for a permanent 21 percent flat corporate income tax rate and a repeal of the corporate AMT for taxable years beginning after December 31, 2017. The Act also reduces the 80 percent dividends-received deduction to 65 percent, and reduces the 70 percent dividends-received deduction to 50 percent. The new lower corporate income tax rate may cause more businesses to utilize the corporate structure, especially in scenarios where there will be limited distributions to shareholders and earnings will be used to pay down debt or finance acquisitions or growth.

Corporate Net Operating Losses. The new tax law limits the deduction for net operating loss carryovers to 80 percent of taxable income, eliminates the carryback of such losses for most companies, and provides for an indefinite carryforward. This provision is generally effective for losses arising in tax years beginning after 2017.

Deduction for Qualified Business Income of Pass-Through Entities. A new deduction will be available to individuals, trusts and estates for qualified business income from pass-through and disregarded entities. Importantly, the deduction against qualifying income would expire for tax years beginning after December 31, 2025.

During the Covered Years, individuals, estates, and trusts may deduct from their taxable income 20 percent of qualified business income from a partnership, S corporation, or sole proprietorship, including a disregarded entity treated as a sole proprietorship, subject to certain limitations.

Generally, a taxpayer's qualified business income is derived from an active trade or business. It excludes any amounts paid by an S corporation treated as reasonable compensation, guaranteed payments to a partner in a partnership, and amounts paid to a partner acting in a capacity other than as a partner. The Act excludes income generated from certain specified service businesses (such as law, health, accounting, and financial services) from qualified business income status if the taxpayer's taxable income exceeds certain thresholds. Interestingly, engineering and architectural firms are not listed as per se service businesses.

The pass-through deduction is limited to the lesser of: (i) 50 percent of the W-2 wages paid by the qualified business, and (ii) 25 percent of the W-2 wages plus 2.5 percent of the depreciable property in service in the qualified business.

Private equity funds and real estate companies whose employees are "housed" in separate related party entities may be limited in taking advantage of this deduction due to the wage limitation. However, this new deduction could mean significant income tax savings for many business owners.

Carried Interest. The Act institutes a three-year holding requirement for carried interests (defined as "applicable partnership interests") to be eligible for long-term capital gain treatment. If such holding requirement is not satisfied, any capital gain recognized by the holder of "applicable partnership interests" will receive short-term capital gain treatment. An "applicable partnership interest" is a partnership interest transferred to, or held by, a taxpayer in connection with the performance of substantial services by the taxpayer or certain related persons in an "applicable trade or business." Covered trades or business are activities that are conducted on a regular, continuous, and substantial basis and that consist, in whole or in part, of:

(1) raising or returning capital; and

(2) either developing, or investing in or disposing of (or identifying for investing or disposition) "specified assets," such as securities, commodities, real estate held for rental or investment, or cash or cash equivalent.

There are two notable carve-outs from the definition of applicable partnership interests. First, a partnership interest held by a corporation is excluded. Second, applicable partnership interests do not include capital partnership interests that provide the partner with the right to share in partnership capital commensurate with the amount of capital contributed or the value of such interest included in income under Section 83 of the Internal Revenue Code upon the receipt or vesting of the interest.

The new provision applies notwithstanding the application of Section 83 to the interest or whether the holder made a Section 83(b) election with respect to the interest. Interestingly, the Act does not include rules "grandfathering" applicable partnership interests held as of the effective date of the Act.

There will likely be future guidance in this area as the new tax law authorizes the U.S. Department of the Treasury to promulgate regulations necessary to carry out the purposes of the provision. Also, portions of the technical language of the provision are ambiguous, so clarifying authority will be necessary.

Business Interest Expenses. Business interest expenses once deductible under Section 163 of the Internal Revenue Code now may be limited to 30 percent of the taxpayer's earnings before interest, tax, depreciation and amortization ("EBITDA") for taxable years beginning after 2017 and before 2022, and limited to 30 percent of a taxpayer's earnings before interest and tax ("EBIT") for taxable years beginning after 2021. At the taxpayer's election, the limitation does not apply to interest incurred by the taxpayer in any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. It also does not apply to regulated public utilities, certain electric cooperatives and taxpayers with average annual gross receipts for the current and prior two taxable years that do not exceed $25 million.

Disallowed interest expenses can be carried forward indefinitely. Also, the business expense limitation is applied at the partnership level for businesses operated in a partnership. Any interest that cannot be deducted by the partnership because of the limit would be allocated to the partners in the same ratio as net income and loss, and could be used in future years to offset any excess income allocations. The exclusion of interest deductions will impact businesses with business interest expenses, particularly taxpayers with large annual revenues beginning in 2021 when the 30 percent limit is applied to a much smaller earnings base.

Bonus Depreciation. The Act modifies bonus depreciation under Section 168(k) of the Internal Revenue Code to allow 100 percent expensing for property placed in service after Sept. 27, 2017, and before January 1, 2023, and then phases out bonus depreciation with 20 percent reductions each year. Property "acquired" before September 28, 2017, including under a binding written contract, will be subject to the old bonus depreciation rules, which is 50 percent through 2017, 40 percent in 2018, and 30 percent in 2019 with no bonus depreciation thereafter. The Act removed the "original use" requirement for bonus depreciation. This means property previously placed in service will qualify for 100 percent bonus depreciation when acquired by another party before January 1, 2023.

Like-Kind Exchanges of Real Property. The Act limits the like-kind exchange rules to exchanges of real property that is not held primarily for sale. Thus, personal property (tangible or intangible) is no longer eligible for like-kind exchange treatment. This new provision applies to exchanges completed after December 31, 2017.

Partnership Technical Terminations. The new tax law eliminates the current rules regarding partnership technical terminations under Section 708(b)(1)(B). Technical terminations occur when 50 percent or more of interests in both profits and capital are transferred in any rolling 12-month period. This results in the technical termination of the current partnership and the formation of a new partnership for federal tax purposes, with depreciation schedules restarted in the new partnership. Many partnership agreements have prohibitions on transfers that could result in a technical termination, including upstream transfers. The removal of the partnership technical termination rules will allow partners to more easily make transfers of their partnership interests, and even avoid indemnification if the partnership documents required indemnification by the transferring partner for technical terminations.

Section 199 Deductions. The Act eliminates the deduction for income attributable to domestic production. Section 199 of the Internal Revenue Code allowed for a 9 percent deduction from income for qualifying production activities income, including the domestic manufacture of tangible personal property or computer software and energy generation from renewable energy projects. The elimination of this deduction will impact owners of qualifying production property since the deduction is no longer available.

International Tax.

New Participation Tax Exemption. The Act adopts a "territorial" tax regime and exempts from U.S. tax the foreign-source portion of dividends received from certain foreign corporations. In concept, the exemption is similar to the "participation exemption" available under the laws of many foreign countries and used by foreign corporations resident in that country to avoid tax on dividends received from foreign subsidiaries. Newly enacted Section 245A of the U.S. Internal Revenue Code provides a 100 percent dividends-received deduction for certain eligible U.S. shareholders. To be eligible, the recipient must be a U.S. C corporation that owns at least 10 percent of the stock of the paying foreign corporation—and has retained that stock ownership for a specified period of time. The exemption is not available to S corporations or individuals.

Tax on Deemed Repatriation of Accumulated Foreign Earnings. To prevent U.S. corporations from using the new U.S. tax exemption to repatriate, on a tax-free basis, cash accumulated by foreign subsidiaries in prior years, the Act requires certain U.S. taxpayers to include in taxable income the taxpayer's allocable share of a foreign corporation's pre-2018 accumulated foreign earnings, as adjusted for foreign deficits and other items. These earnings will be subject to U.S. tax at an effective tax rate of 15.5 percent, to the extent attributable to cash or certain other liquid assets, or an effective tax rate of 8 percent if the earnings have been reinvested by the foreign corporation in illiquid assets. These effective rates are derived via a new deduction that has the effect of reducing the U.S. taxpayer's higher statutory tax rate to the reduced 15.5 percent or 8 percent effective rate.

Notably, shareholders in certain S corporations will be required to include in taxable income their allocable shares of the foreign corporation's unremitted earnings. To minimize the tax impact to S corporation shareholders, however, the Act defers or postpones the time at which this additional U.S. tax must be paid. More specifically, a U.S. C corporation must pay U.S. tax on its allocable share of unremitted foreign earnings over an eight-year period (with an acceleration in the event of certain triggering events). Shareholders of an S corporation, however, may elect to defer payment of this U.S. tax until there is a triggering event. Notably, the definition of a "triggering event" includes the termination of S corporation status and the sale of S corporation stock. Further, the S corporation is liable in the event the shareholder fails to pay such tax. Thus, shareholders of an S corporation that are subject to this new U.S. tax on unrepatriated foreign earnings must carefully consider any actions that would accelerate the payment of this tax.

Rules to Minimize Base Erosion: The Act creates a new base erosion and anti-abuse tax (the "BEAT"). The BEAT is intended to apply to companies that significantly reduce their U.S. tax liability by making cross-border payments to affiliates. The BEAT applies if 10 percent of the cross-border payment amounts exceed the company's regular U.S. tax liability.

The Act adopts a number of base erosion provisions, including the following:

- Denial of new participation tax exemption (discussed above) for passive foreign investment company (PFIC) dividends and purging distributions.

- Recapture of accumulated losses upon incorporation of a foreign branch.

- Repeal of Section 367(a)(3), which currently permits U.S. taxpayers to transfer active trade or business assets to a foreign corporation on a tax-deferred basis.

- Expansion of the pool of items of intangible property (including goodwill) that, if transferred by a U.S. taxpayer to a foreign corporation, would be subject to tax.

- New Code Section 951A, by which some U.S. taxpayers will pay tax on certain income earned by controlled foreign corporations in excess of a specified return on tangible business assets.

- New Section 250, by which U.S. corporations that derive certain income from unrelated foreign persons will benefit from a new tax deduction.

- Adoption of an anti-inversion rule that denies the participation exemption and imposes a 35 percent tax rate (and applies certain other rules) in respect of "expatriated entities" during the 10-year period following enactment of the Act

Other Tax Rules. The Act also amends, repeals, or enacts a number of other U.S. tax rules. For example, among other changes, the Act expands the definition of "U.S. shareholder" for purposes of the Subpart F rules, repeals the foreign tax credit available under Section 902 in respect of future foreign dividends and creates a new foreign tax credit limitation, and revises source rules for sales of inventory and certain partnership interests.

The tax law's changes to domestic, international and cross-border transactions will have a significant impact on the structure and operation of transactions. In addition to creating additional complexity, these changes raise new issues for U.S. taxpayers that own, acquire or sell U.S. or foreign business ventures. Businesses and business owners need to carefully re-evaluate their transaction and operational structures in light of the Act.

Charitable Issues

Charitable Contribution Deduction. For the Covered Years, the annual limit on aggregate deductions for gifts to public charities and certain other organizations will increase from 50 percent to 60 percent of adjusted gross income. At the same time, the standard deduction will almost double—from $6,350 to $12,000 for single individuals and from $12,700 to $24,000 for married couples—and will be indexed for inflation, and deductions for state and local taxes, mortgage interest, uncompensated employee expenses, casualty losses, home equity loans, gambling losses, and miscellaneous itemized deductions will be substantially curtailed.

These changes, coupled with the increased transfer tax exemptions described below, seem likely to cause a dramatic reduction in the number of donors who can derive any tax benefit from their charitable gifts.

The Act prohibits donors from deducting amounts paid for the right to purchase tickets to college athletic events. Current law allows a charitable deduction for 80 percent of such payments.

The Act also allows an electing small business trust (which is a type of trust eligible to own stock in an S corporation) to follow the charitable contribution deduction rules for individuals, including applicable percentage limitations and carryforward provisions.

Additionally, the Act eliminates the statutory provision that excuses a donor from obtaining a contemporaneous written acknowledgement of a charitable gift if the donee organization files a return with the required information.

Unrelated Business Income Tax (UBIT). The Act requires tax-exempt organizations to calculate income from each unrelated trade or business separately and prohibits them from offsetting taxable income from one such activity with losses from another.

Colleges and Universities. The Act imposes a 1.4 percent excise tax on private college and university endowments that have at least 500 students (more than 50 percent within the United States) and have investment assets valued at $500,000 or more per full-time student. Investments of any organization related to the college or university, including supporting organizations, would count toward the asset threshold. Below are a few additional notes regarding the applicability of these provisions:

- The Act counts all students, not just "tuition-paying" students, in determining whether the tax applies to a particular institution.

- Investments of any organization related to the college or university, including supporting organizations, would count toward the asset threshold.

- The tax would not apply to endowments of public colleges and universities.

Approximately 27 universities and colleges will be affected by this tax.

Exempt Organizations as Employers. A tax-exempt employer would pay excise tax at the corporate rate (21 percent under the Act) on compensation of more than $1 million paid to any of its five highest-paid employees. The tax also would apply to a parachute payment that exceeds three times the base salary of a "highly compensated employee" (under current Section 414(q)). Compensation would be treated as being paid when rights to it are not subject to a substantial risk of forfeiture. A special exclusion applies to payments to a licensed medical professional for medical or veterinary services.

Tax-exempt employers also would pay unrelated business income tax on the value of transportation fringe benefits and on-premises gyms and other athletic facilities that employees can exclude from their taxable income.

Financing for Exempt Organizations. The Act would impose income tax on interest from advance refunding bonds and prohibit issuance of tax credit bonds after 2017.

Broadening Recipients for 529 Accounts. The Act would allow payments of up to $10,000 per student for each taxable year from 529 college savings plans to elementary and secondary schools, including public, private, or religious schools. Qualified expenses would include tuition, fees, books, and other related costs. A provision to include the costs of home schooling was removed. The Act also permits transfers to an ABLE Account (which were created by the Achieve a Better Life Experience Act of 2014) for individuals with disabilities that will not affect their qualification for SSI, Medicaid, and other public benefits.

Provisions Not Included in Act. The final Act did not include several provisions that were in earlier versions of the House and/or Senate bills. Thus, the Act does not:

- repeal deduction for student loan interest;

- repeal deduction for qualified tuition and related expenses;

- repeal exclusion for qualified tuition reductions;

- repeal exclusion for interest on U.S. savings bonds used for higher education expenses;

- repeal exclusion for education assistance programs;

- allow 529 plan accounts to be opened for an *in utero* beneficiary;

- increase 14 cents-per-mile statutory cap on deductions for charitable use of a personal vehicle;
- repeal estate tax or generation-skipping transfer tax;
- impose UBIT on all Internal Revenue Code Section 501(a) organizations;
- impose UBIT on income from research if results are not publicly available;
- impose UBIT on income from sale or licensing of a tax-exempt organization's name or logo;
- modify exclusion for housing provided for the employer's convenience;
- permit private foundations to own an independent for-profit business without violating the excess business holdings rules;
- impose uniform 1.4 percent excise tax on private foundation investment income;
- require private foundation art museums to be open to the public;
- modify intermediate sanctions rules for private foundations;
- repeal new market tax credits;
- repeal private activity bonds;
- impose new disclosure requirements for donor-advised funds;
- prohibit tax-exempt bond financing for pro sports stadiums; and
- modify political campaigning prohibition for Section 501(c)(3) organizations (the so-called "Johnson Amendment").

Planning for Clients after the Tax Act

I. Estate Planning after the 2017 Tax Act

A. While the doubling of the estate tax exemption to $10 million (indexed for inflation) will allow most individuals to escape federal estate taxes, estate planning will still be necessary to permit an individual to pass assets to his or her beneficiaries in the form that he or she would like. This could include outright gifts or gifts in trust. One has only to look at the contest over the estate of Prince, who died in 2016 with no will, to see the value of estate planning. Prince's heirs came out of the woodwork to fight over his estate.

B. The Internal Revenue Service provides the following information on the number of estate tax returns filed in 2016, the latest year for which information is available.

1. Of all 12,411 estate tax returns filed in 2016, 8,270 (2/3 of all returns filed) reported a gross estate LESS THAN $10 million. 4,142 returns were filed with a gross estate MORE THAN $10 million. Under the 2017 Tax Act, only about 1 out of every 3 returns filed last year would be required to file in coming years. 12% of all returns were for estates over $20 million. The table looks like this:

All Returns Reporting < $10 million	8,270
% of All Returns Filed	67%
All Returns Reporting Gross Estate > $10 million	4,142
% of All Returns Filed	33%
All Returns Reporting Gross Estate > $20 million	1,507
% of All Returns Filed	12%

2. One interesting note: The IRS tracks attorneys' fees as a deductible expense in a separate column. The total attorneys' fees claimed on all returns filed in 2016 with gross estates LESS THAN $10 million was approximately $213 million dollars ($25 million for estates less than $5 million; $188 million for estates between $5 to $10 million). No doubt some percentage of attorneys' fees will still be required for administration, but this could be a significant impact on the estate tax return preparation industry.

3. One relevant consideration regarding returns reporting assets of $20 million or more is whether the return is subject to tax. If one assumes that a married couple could take advantage of the basic exclusion amount up to $22 million, one might assume that some significant percentage of the taxable returns filed in 2016 reporting gross estates more than $20 million dollars reflects the number of taxpayers, going forward, that will PAY estate tax annually. This does not account for a married couple that makes significant lifetime gifts and it does not account for the number of taxpayers that use the charitable deduction, or for another reason, do not end up paying tax at the death of the survivor. But the number of returns that reported paying tax in 2016 with a gross estate of more than $20 million is 911, or 7% of all returns filed.

C. The estate plans of all clients should be reviewed to determine the possible impact of the changes in the estate, gift, and generation-skipping taxes on them.

D. Summary of Possible Strategies:

1. Updating of estate plans to match intent of clients with exemption.

2. Broad line division between estates under $20 million and equal to or above $20 million.

3. Examine strategies to protect against future drop in exemption (such as expiration of current exemption in 2026 or earlier or later action by a new administration and Congress.

4. Continued role of techniques such as gifts, long-term trusts, GRATs, SLATs, and sales to defective grantor trusts

5. Late allocation of additional GST exemption to existing trusts to improve efficiency.

6. Modification of QTIP Trusts and GST Trusts to pick up basis step-up.

7. Structure of businesses.

8. Is there a conflict between the basis adjustment and discounts in planning?

E. Planning for Individuals Not Subject to Estate Tax and for Whom Planning is Unnecessary to Avoid Estate Tax

1. Primary Objectives

a. An estate plan is a plan for transporting one's wealth. Like any transportation plan, it designates a destination—the persons who will receive the property. It also can provide instructions on how the property may be used. In transportation, minimizing breakage is a goal. Likewise, in an estate plan, minimizing loss of property, to taxes or to waste, is an important goal in establishing a plan to pass property as the client wishes.

b. In order to accomplish these goals, an individual will need to formulate his or her specific objectives and desires about the disposition of his or her property, the use of trusts, and the appointment of fiduciaries. The estate planning professional must assist the individual in this process by explaining the available alternatives, and the impact of tax planning and creditor protection considerations.

c. Wills, revocable trusts, powers of attorney, and medical directives will still be needed for individuals not subject to estate tax.

F. Benefits of Placing Property in Trust

1. Individuals often believe that they need nothing more than a simple will if their estates are below the applicable exclusion amount and they do not anticipate that federal estate tax will be due at either their death or the

death of their spouse. A will that leaves all the assets to the spouse and, upon the spouse's death, divides the assets equally among the children is considered sufficient to protect the family adequately. A closer look points out the risks inherent in such a plan.

2. If an individual leaves even modest amounts of money to a spouse who has never had any experience with financial management and investment decisions, he or she may be placing an unfair burden upon the spouse. This type of burden translates into anxiety instead of security.

   a. The surviving spouse may remarry, and all or a portion of the assets originally intended to go to children may end up in the hands of the new spouse, or children of the second marriage.

   b. Even if the surviving spouse does not remarry, he or she may be put in the position of saying "no" to a child who wishes to use the inherited wealth for a risky new business venture or some speculative investment. Depending upon the relative strengths of the child and surviving spouse, imprudent decisions may be made which could rapidly dissipate the property left for the family.

   c. A surviving spouse who has been insulated from financial matters may, upon receiving an inheritance, may fall prey to unscrupulous people who do not act in the spouse's best interests. Alternatively, the surviving spouse could become overwhelmed by the immediate feeling of wealth and independence and live in a manner that could quickly exhaust the remaining estate.

3. By using trusts to transfer property, either during life or at death, the donor is able to maintain an element of control over the property. The donor can designate under what circumstances and for what purposes a beneficiary will receive that property or its income. Trusts also permit the donor to determine who will manage the property as trustee. Other advantages of trusts include the following:

   a. Retention of property in trust preserves the benefits of the investment and management skills of the trustee.

   b. A trust can protect assets from the claims of third-party creditors of the beneficiary, such as the plaintiff in a lawsuit or a spouse in a failed marriage. Generally, a creditor or litigant cannot gain access to assets set aside in a properly drafted trust by someone other than the beneficiary. The same is generally true with respect to a divorcing spouse, although state law varies on the degree to which courts can consider the existence of trust assets in determining the division of assets upon divorce.

c. Children who have not fully matured may rapidly dissipate an outright inheritance, whereas a trust can provide for incremental distribution of inheritances.

d. Large outright distributions may spoil children and destroy their incentive to provide for self-support.

4. On the other hand, an overly restrictive trust may prevent an entrepreneurial child from reaching the property and exploiting a business opportunity. A well-drafted trust can be flexible enough to allow a capable beneficiary to take advantage of such opportunities.

5. Placing property in trust may grandfather trust assets from future estate tax changes such as a return to the pre-2018 rules in 2026 as provided in the Act.

G. Advising on Creditor Protection

1. Basic Creditor Protection

a. <u>Outright Gifts of Property</u>. Outright gifts are a simple way for a client to protect his or her assets from the claims of future creditors. Assets that the client gives away are no longer subject to seizure by the client's creditors. However, if the client is insolvent, or would become insolvent by making the gift, there may be consequences under the Fraudulent Conveyance statutes.

b. <u>Trusts</u>. Trusts may be the most important regularly used and accepted asset protection tool available. For transfer of property by gift, a trust can be used to alleviate the client's concerns about the beneficiary's imprudent use of the property.

c. <u>Co-Ownership</u>. Different forms of co-ownership, such as tenancy by the entirety, joint tenancy with right of survivorship, and tenancy in common, may provide some protection against creditors.

d. <u>Trusts for Disabled Beneficiaries</u>. The most likely potential creditor of a disabled beneficiary is the federal, state, or local agency that provides public assistance to that beneficiary. Over the past 10 to 15 years, public agencies have become more aggressive in seeking reimbursement for the cost of caring for disabled persons. Many states have passed laws that permit agencies to seek reimbursement and that define the assets which are available to the government agency. These statutes must be considered carefully when drafting a trust that is designed to provide supplemental benefits to a disabled person in order to improve the quality of the person's life without having the entire trust subject to confiscation by a government agency.

(1) State case law is not consistent in defining the standard of distribution that will cause trust assets to be chargeable for a disabled beneficiary's care. In many states, a trust that allows the trustee to make distributions for the "support and maintenance" of a beneficiary will be treated as an asset of the beneficiary for the purpose of determining eligibility for public aid. However, in other cases, a state has been unable to obtain reimbursement for public aid where the trust instrument allowed the trustee to use principal for the beneficiary's support and maintenance (especially in cases in which the trust instrument evidenced the testator's intent that trust assets merely supplement support from other sources). Many state legislatures are now attempting to provide statutory guidelines for when trust assets will be considered available to the beneficiary for the purpose of qualifying the beneficiary for public assistance or allowing the state to seek reimbursement from trust assets.

e. <u>Exempt Assets</u>. Separate and apart from the protection of a tenancy by the entirety arrangement, most states have a homestead exemption that allows an individual to always retain a certain amount of equity in their residence. In many states, the exemption is limited; for example, in Illinois, it is $7,500. Florida and Texas, however, have homestead exemptions that allow residents to retain all the equity in their home and adjacent land, subject to certain size (but not value) limitations.

(1) Florida allows a homestead exemption for properties of up to 160 acres outside a municipality, and up to one-half acre inside a municipality.

(2) Texas has a rural homestead exemption for up to 200 acres for a family, 100 acres for a single person; and an urban homestead exemption for up to one acre.

f. <u>Life Insurance</u>. Many states exempt life insurance and annuity contract proceeds or cash value or both from the reach of creditors. In some states, like Illinois, the exemption is available only if the insurance is payable to a member of the immediate family or other dependent. Variable life insurance policies and variable annuity contracts can have a significant investment element. In fact, they frequently are sold as an alternative investment vehicle, with the insured/annuitant being able to invest in a number of mutual funds inside the policy or contract. Thus, an individual can use an investment-oriented insurance policy as an alternative to transferring property in trust.

g. Retirement Plans. Both ERISA and the laws of many states protect qualified retirement plans from creditors. Individual retirement accounts are not subject to the ERISA protections, but are protected under the laws of some states, like Texas. One simple asset protection step for a person in a high-risk profession is to take maximum advantage of opportunities to contribute to qualified retirement plans.

2. Premarital Agreements

a. Work will be needed to provide for the distribution and ownership of assets for couples about to marry.

b. Premarital agreements will continue to be an important component of this advice and planning.

3. Limited Partnerships

a. The family-owned partnership has become a popular vehicle for managing and controlling family assets. A typical family partnership is a limited partnership with one or more general partners and limited partners. The family partnership provides a number of benefits, both tax and non-tax, including investment efficiencies, valuation discounts, transfers of value without relinquishing control, and restrictions on further transfer of limited partnership interests.

b. With respect to asset protection planning, a limited partner's personal exposure for the debts of the partnership is generally limited to his investment in the partnership. This prevents a creditor of the partnership from reaching the personal assets of a limited partner to satisfy debts owed by the partnership.

c. A limited partnership also can provide a modest level of creditor protection against creditors of a partner who are seeking assets to satisfy a debt or judgment. Almost every state has enacted a version of the Revised Uniform Limited Partnership Act ("RULPA"). RULPA helps protect a limited partnership interest from the claims of creditors of the partner by mandating an unattractive remedy for a creditor seeking that partner's interest.

d. Usually, the sole remedy provided to creditors with respect to a debtor's interest in a limited partnership is the charging order. Section 703 of RULPA provides that a court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. Under Section 702 of RULPA, the assignee judgment creditor is only entitled to receive those distributions to which the debtor partner would have been entitled, unless there is a contrary provision in the partnership agreement. The effect of the charging order is that a partner's creditor will only receive those partnership distributions which, absent the charging order, would have been distributed to the debtor partner.

4. Limited Liability Companies

a. The limited liability company ("LLC") is a viable alternative to the use of a limited partnership. The LLC first became available in Wyoming in 1977 and is now available in almost every state. The LLC has the limited liability of a corporation, but preserves the flow-through treatment of taxable income (or loss) of a partnership. The LLC can provide an attractive alternative to the use of a general or limited partnership, especially where there is a desire to limit the personal liability of the family members in relation to the activities of the entity.

b. With respect to asset protection issues, many state LLC statutes contain charging order Sections similar to that found in the RULPA. Also, LLC statutes generally contain the following types of provisions which provide protection quite similar to the protection afforded by a limited partnership:

(1) A member's interest in an LLC is personal property and is not an interest in specific assets of the LLC;

(2) An assignee will not become a member of the LLC without the unanimous consent of the other members; and

(3) An assignee who is not a member is only entitled to receive the share of profits and income to which the assignor is entitled and has no right to participate in the management of the LLC.

5. Domestic Asset Protection Trusts

a. Certain states permit the settlor of an irrevocable trust to obtain spendthrift protection from an irrevocable trust if certain require are met.

b. While Missouri was the first state to enact Domestic Asset Protection Trust legislation in 1986, few attorneys outside of Missouri paid attention to it or were even aware of it. However

Domestic Protection Trusts gained public awareness when, in 1997, both Alaska and Delaware enacted legislation permitting Domestic Protection Trusts.

c. As of January 1, 2018, the following 18 states allow such self-settled asset protection trusts: Alaska, Colorado, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.

d. The requirements of such a trust vary by state, but basic requirements in each of these Domestic Asset Protection States are the following:

(1) There must be a resident trustee in the state.

(2) Some of the assets of the trust must be held in the state.

(3) Some of the administration of the trust must take place in the state.

(4) The transfer of assets to the domestic asset protection trust cannot be a transfer in fraud of creditors.

(5) The trust must be irrevocable.

(6) The settlor is a discretionary beneficiary of the income and principal of the trust.

6. Offshore Protection Trusts

a. Offshore Protection Trusts have become one of the most talked about estate planning techniques for many years. They are heavily promoted as effective barriers against claims of creditors because the laws of most offshore trust havens make it difficult for creditors to obtain jurisdiction over, or levy against, a trust, even if the settlor retains an interest in the trust property. Unlike most states of the United States, a number of foreign jurisdictions, usually former British colonies or current British dependencies permit a settlor to create a spendthrift trust for his or her own benefit. These barriers often insulate the property entirely from creditors, or produce early and inexpensive settlements.

b. Creditor Protection Benefits

(1) An Offshore Protection Trust can create geographic, legal, procedural, and financial hurdles to reaching its assets.

(2) The mere fact that a trust is a foreign trust may deter creditors from pursuing the trust. This is particularly likely if the trust is funded with assets from the foreign jurisdiction. The cost of pursuing a claim against a foreign trust can be high, especially since foreign jurisdictions may prohibit contingent fee litigation or require significant deposits to commence a proceeding.

(3) Some jurisdictions, such as the Cook Islands, do not recognize foreign judgments. Thus, an action first brought in a United States court may have to be tried all over in a foreign jurisdiction.

(4) As mentioned, many foreign jurisdictions have favorable spendthrift trust provisions which protect the interests of a settlor-beneficiary. Such provisions are in contrast to dominant rule in the United States that one may not create a spendthrift trust for one's own benefit.

7. Individuals may still want to establish long-term trusts that could last several generations to protect assets from creditors, to provide centralized management of assets, and also to protect the assets in the trust from the imposition of a future estate, gift, or generation-skipping transfer tax.

a. The ability to established long-term irrevocable trusts for several generations has been greatly aided by the enactments of laws in many states that have either eliminated or greatly extended the common law rule against perpetuities. In fact, without a gift tax, unlimited amounts could be placed in such a trust.

b. The common law Rule Against Perpetuities (the "Rule") provides that no interest is valid unless it vests or fails within a life in being plus twenty-one years. Currently, twenty states effectively have abolished the Rule. Nine states have repealed the Rule outright. A tenth (Delaware) has repealed the Rule with respect to interests in personal property. An additional nine states and the District of Columbia have preserved the Rule, but have granted trust settlors the authority to opt out of it by including specified provisions in their trust instruments. In 2000 Florida extended the perpetuities period to 360 years, and in 2001 Washington extended it to 150 years. In 2003, Utah extended its perpetuities period to 1,000 years. Also, in 2003, Wyoming adopted an opt-out provision for personal property and extended the perpetuities period to 1,000 years. In 2005, Nevada extended the perpetuities period to 365 years. In 2006, Colorado extended the perpetuities period to 1,000 years. In 2007, Tennessee extended the perpetuities period to 360 years.

c. Repeal Legislation. Statutory provisions in Alaska, Idaho, Kentucky, New Jersey, Rhode Island, South Dakota, and Wisconsin each provide that the Rule is not in force in the respective states, while Pennsylvania provides for this for interests created after December 31, 2006. Statutes in effect in Idaho, South Dakota, and Wisconsin provide that the repeal of the Rule applies retroactively. By contrast, New Jersey's statute provides that it shall not be applied retroactively. It is unclear whether the repeal of the Rule in Alaska or Rhode Island applies retroactively. North Carolina repealed the Rule effective August 9, 2007. A state constitutional problem arose because of the provision of Section 34 of Article I of the North Carolina Constitution that provides "Perpetuities and monopolies are against the genius of a free state and shall not be allowed." On February 2, 2010, the North Carolina Appellate Court upheld the constitutionality of the North Carolina repeal. Hawaii repealed the Rule with respect to its form of domestic asset protection trust that became effective July 1, 2010.

d. Delaware and Michigan Partial Repeal Legislation. Delaware has repealed the Rule only with respect to interests in personal property, but replaced the common law Rule with a perpetuities period of 110 years for real property held in trust. It is unclear whether either of these provisions apply retroactively to existing trusts. Michigan has repealed the Rule with respect to personal property effective May 28, 2008.

e. Opt-Out Legislation. The remaining twelve states (plus the District of Columbia) that have effectively abolished the Rule have done so by providing settlors with the power to opt out of the Rule's application to their trusts. These states include Illinois, Maine, Maryland, Ohio, Arizona, Colorado, Missouri, New Hampshire, Virginia, and Wyoming.

8. Irrevocable Life Insurance Trusts

a. Clients may still create irrevocable life insurance trusts as a way to transfer the death benefits of life insurance policies to family members without adverse gift tax consequences even if there are no estate tax consequences. They may do so to provide creditor protection to the beneficiaries. This will require planning in many instances to qualify transfers to the trusts for the gift tax annual exclusion through the use of Crummey powers and to minimize the exposure of the holders of the Crummey powers to potential gift tax exposure through the use of vested interests or hanging powers of withdrawal for example.

H. Income Tax Planning

1. Clients will still need advice on both federal and state income taxes.

2. Federal Fiduciary Income Tax

a. The fiduciary income tax found in Subchapter J of the Internal Revenue Code is one of the more complex and confusing tax provisions.

b. Among the complex areas of Subchapter J are:

(1) What makes a trust a grantor trust for income tax purposes?

(2) Distributable Net Income ("DNI") and what it really means.

(3) The lack of simplicity of simple trusts, and the complexity of complex trusts.

(4) The limitations on deductibility of trust expenses.

(5) Timing distributions to the advantage of beneficiaries.

(6) Making the Section 645 election work for clients.

(7) The ins and outs of equitable adjustments and private unitrusts.

3. Changes brought about by the 2017 Tax Act

a. The 2017 Tax Act continued the compression of the income tax rates for irrevocable non-grantor trusts and estates with the top 37 percent rate applying to income greater than $12,500 compared with the top 37 percent rate for unmarried individuals applying to income over $500,000.

b. The 2017 Tax Act added a new Section 67(g) which provides that no miscellaneous itemized deductions (which previously could be taken to the extent that they exceeded two percent of adjusted gross income) will be allowed for the tax years 2018 through 2025. Most commentators believe that the Section 67(g) prohibition on taking deductions does not apply to the expenses covered by Section 67(e), which permits a full deduction for expenses which would not have been incurred if the property were not held in an irrevocable non-grantor trust or estate.

c. The following items should continue to be deductible for irrevocable non-grantor trusts and estates:

(1) State and local income and property taxes on assets held in a trust or estate up to the $10,000 cap.

(2) State personal and real estate taxes on a trade or business owned by a trust or estate.

(3) Interest (subject to the same rules and limits as before 2018)

(4) Charitable distributions for amounts specifically allocable or payable to charity by the governing will or trust instrument pursuant to Section 642(c).

(5) Amortized bond premiums and original issue discount.

(6) Depreciation and depletion expenses.

(7) Costs of preparing estate tax returns and fiduciary income tax returns.

(8) Legal fees related to the administration of a trust or estate.

(9) Administrative fees for items such as appraisals and accountings.

4. State Income Taxation of Irrevocable Non-grantor Trusts

a. Currently seven states—Alaska, Delaware, Florida, Nevada, South Dakota, Texas, Washington and Wyoming—do not tax the income of trusts. The other states and the District of Columbia do tax the income of trusts to a greater or lesser extent.

b. If a trust is treated as a grantor trust for federal income tax purposes, all income (ordinary and capital gains) will be taxed to the grantor of the trust. Most states follow the substance of the federal grantor trust rules. If a trust is a grantor trust for federal income tax purposes, the trust will be treated as a grantor trust for state income tax purposes. Pennsylvania and Tennessee do not follow the federal grantor trust rules for irrevocable trusts.

c. Every state follows the rule that to the extent that income is distributed from an irrevocable non-grantor trust to a beneficiary, the beneficiary pays the tax and not the trust. Consequently, in examining the income taxation of a trust or estate from a state law perspective, one is primarily looking at the taxation of income accumulated in a trust as well as capital gains.

d. In the remainder of this Section, the focus will be on the state income taxation of irrevocable non-grantor trusts. Non-grantor irrevocable trusts are generally taxed for state income tax purposes on one or more of the following bases:

(1) The trust was created pursuant to the will of a testator who lived in the state at the time of his or her death.

(2) The creator of an inter vivos trust lived in the state at the time the trust became irrevocable.

(3) The trust is administered in the state.

(4) One or more trustees live or do business in the state.

(5) One or more beneficiaries live in the state.

e. The trust that meets one or more of the bases for taxation in a state is generally referred to as a "Resident Trust."

f. The bases for the state income taxation of non-grantor trusts vary from state to state:

(1) <u>Trust created by will of resident</u>. Connecticut, District of Columbia, Illinois, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, Ohio, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia, and Wisconsin tax a trust that is created by the will of a decedent who was a resident of the state at the time of his or her death. Other states, such as New Jersey and New York, require that such a trust have Resident Trustees, assets, source income, or a resident beneficiary before they will tax such a trust.

(2) <u>Inter vivos trust created by resident</u>. The District of Columbia, Illinois, Maine, Maryland, Minnesota, Nebraska, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia, and Wisconsin tax an inter vivos trust if it becomes irrevocable when the creator lived in the state.

(3) <u>Trust administered in the state</u>. Colorado, Georgia, Indiana, Kansas, Louisiana, Maryland, Minnesota, Mississippi, Montana, New Mexico, North Dakota, Oregon, South Carolina, Virginia, and Wisconsin tax the trust if a trust is administered in that state. Idaho and Iowa tax a trust if it is administered in the state if this basis is

combined with other factors. Hawaii requires that a trust administered in Hawaii have at least one resident beneficiary for the trust to be taxed in Hawaii. Utah, since 2003, has permitted a Utah corporate trustee to deduct all nonsource income of a trust administered in Utah.

(4) Resident Trustee. Arizona, California, Georgia, Kentucky, Montana, New Mexico, North Dakota, Oregon and Virginia tax an irrevocable trust if one or more trustees reside in the state.

(5) Resident beneficiary. California, Georgia, North Carolina, North Dakota and Tennessee tax a trust if it has one or more resident beneficiaries.

g. State laws vary considerably on the rules on which state income tax is based. One must look at the law of each state in determining whether that state's income tax will apply to a particular trust.

h. As can be seen above, some states apply more than one basis in determining whether a trust is subject to income taxation of that trust. For example, Virginia taxes the income of a non-grantor trust if (i) the trust was created by the will of a Virginia decedent; (ii) the trust was created by a Virginia resident; (iii) the trust is administered in Virginia, such as, for example, its assets are located in Virginia or its fiduciary is a resident of Virginia.

i. Examples of different states:

(1) The opportunity for reducing taxes can be important. State fiduciary income tax rates range from 3.07% in Pennsylvania to as high as 12.846% in New York City.

(2) New York. New York defines a Resident Trust as a trust created by a New York resident or grantor. New York does not tax a trust if a trust has no New York trustees, assets, or source income.

(3) Connecticut. Connecticut basically taxes irrevocable trusts that are created by a Connecticut testator or a person who is a resident of Connecticut at the time the trust became irrevocable.

(4) Delaware. Delaware generally does not impose any income tax upon Resident Trusts except in cases where one or more trust beneficiaries live in Delaware and then only upon the portion of the trust income attributable to the beneficiaries who reside in Delaware.

(5) Maryland. Maryland taxes an irrevocable trust created by a Maryland testator or grantor if the trust was created under the will of a decedent domiciled in Maryland on the date of decedent's death, the creator or grantor of the trust is a current resident of Maryland, or the trust is principally administered in Maryland.

(6) Virginia.

(a) Virginia, as noted above, has a broad definition of a Resident Trust subject to Virginia taxation. The definition is:

> A trust created by the will of a decedent who at his death was domiciled in the Commonwealth; a trust created by or consisting of property of a person domiciled in the Commonwealth; or a trust which is being administered in the Commonwealth.

(b) The Virginia Administrative Code expands on this definition by adding that a trust is considered to be administered in Virginia if "its assets are located in Virginia, its fiduciary is a resident of Virginia or it is under the supervision of a Virginia court."

(7) Missouri. A trust will be subject to Missouri income tax if it was created by the will of a Missouri decedent or it is an inter vivos trust created by a Missouri resident. In addition, the trust must have a resident income beneficiary on the last day of the taxable year if the trust is to be subject to tax in Missouri.

(8) California. A trust is a California resident for income tax purposes if a trustee or non-contingent beneficiary is a resident of California, regardless of the residence of the settlor. With respect to corporate fiduciaries, the residence of the corporate fiduciary is the place in which the corporation conducts the major portion of the administration of the trust.

j. Given the complexity of and the differences between the rules governing the income taxation of trusts and estates by different states, an irrevocable non-grantor trust may be subject to income taxation in more than one state.

k. Responses to DING trusts, NING trusts, and Attempts to Minimize State Income Tax

(1) A "DING" trust, or "Delaware Incomplete Non Grantor" Trust, is an irrevocable trust established under the laws of Delaware. When established in Nevada, such a trust is referred to as a "NING" trust.

(2) Such a trust has the following features:

(a) The trust is irrevocably established in a jurisdiction without state income tax on trusts (in the case of a DING, Delaware; and in the case of a NING, Nevada) by a settlor from another jurisdiction;

(b) The settlor retains sufficient control such that the trust is treated as an incomplete gift for federal gift tax purposes and does not trigger gift tax upon its creation; and

(c) The settlor does not retain any power that would cause the trust to be treated as a "grantor" trust for income tax purposes, such that the trust, and not the settlor, is taxed on the income of the trust.

(3) In a series of private letter rulings, the IRS has confirmed that a trust may be established where the grantor parts with sufficient control such that the settlor is not treated as the grantor for federal income tax purposes, but where the settlor retains sufficient control so that the gift is deemed to be incomplete for federal gift tax purposes.

(4) The DING or NING trust offers no savings from federal income tax, because the trust still must pay federal income tax on any income.

(5) However, the trust can offer savings from state income tax, because the trust is designed to be treated as a resident only of the forum state, and the trust would pay no income tax in that state.

(6) Generally, New York taxes "Resident Trusts" on income, regardless of whether that income comes from sources located in New York.

(7) New York's Response to DING/NING Trusts

(a) New York law generally defines a "Resident Trust" as:

(b) a trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in this state, or

(c) a trust, or portion of a trust, consisting of the property of:

> "(i) a person domiciled in this state at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or
>
> (ii) a person domiciled in this state at the time such trust, or portion of a trust, became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable."

(d) New York law provides, however, that even if a trust is created by a New York resident as provided above, a Resident Trust is not subject to tax if all of the following are satisfied:

> "(i) all the trustees are domiciled in a state other than New York;
>
> (ii) the entire corpus of the trusts, including real and tangible property, is located outside the state of New York; and
>
> (iii) all income and gains of the trust are derived from or connected with sources outside of the state of New York."

(e) <u>Prior Law and DING/NING Trusts by New York Resident</u>. Under prior law, if a trust was created by a New York resident, but has no New York resident trustee, no assets located in New York, and no New York source income, then the trust pays no New York income tax. This tax savings can be considerable. Currently, New York has a state capital gains rate of 8.8%.

(f) <u>Current Law and DING/NING Trusts by New York Residents</u>. However, in 2014 New York adopted a statute to expressly address such DING/NING trusts. This law classifies such DING/NING trusts as grantor trusts for purposes of New York state law. This law provides that a trust is treated as a Resident Trust if the grantor is a New York resident, if the transferor is not treated as grantor for federal tax purposes, and if the transfer to the trust is an incomplete gift for federal gift tax purposes. The statute taxes in New York the assets of an "incomplete gift non-grantor trust," which is defined as follows:

> an "incomplete gift non-grantor trust" means a resident trust that meets the following conditions: (i) the trust does not qualify as a grantor trust under … the Internal Revenue Code, and (2) the grantor's transfer of assets to the trust is treated as an incomplete gift under … the Internal Revenue Code, and the regulations thereunder.

That is, the statute expressly reaches trusts which (1) are non-grantor trust for federal income tax purposes, and (2) result from an incomplete gift for federal income tax purposes.

I. Charitable Planning

1. Many opportunities exist for enhanced charitable giving by trust and private banking customers. This is especially true when one examines the history of charitable giving by Americans.

    a. Americans are among the most generous people, ranking second only to Canadians in terms of average donations to charity.

    b. In 2016, Americans gave $390.05 billion to charities. This was a $10.16 billion increase over charitable giving in 2015 (<u>Giving USA 2017: The Annual Report on Philanthropy for the Year 2016</u>, published by Giving USA Foundation, and researched and written by the Center on Philanthropy at Indiana University).

    c. Individuals gave $281.86 billion and contributed 72¢ of each dollar given to charity in 2016.

    d. Bequests totaled $30.36 billion in 2016.

e. Corporate giving was $18.55 billion in 2016.

f. Far more than one million charities are presently recognized by the IRS.

2. Given the generosity of individuals, coupled with the overwhelming value of the future transfer of wealth between generations, many opportunities will exist for charitable planning no matter what happens in the future,

3. Income Tax Deduction for Charitable Contributions. The deductibility of charitable contributions for income tax purposes is subject to two types of limitations. These two limitations often make charitable planning challenging.

   a. Percentage Limitations. There are "percentage limitations" on the amount that an individual may claim as a charitable deduction against his gross income in any tax year.

   b. Valuation Limitations. With respect to certain appreciated property contributed to charity, the individual may be required to use the property's tax basis, rather than its fair market value at the time of the contribution, for the purpose of determining the deductible amount of the contribution.

4. Substantiation Requirements. The IRS may disallow an individual's income tax charitable deduction if it is not properly substantiated. Recordkeeping requirements apply to all charitable contributions. Additional appraisal requirements apply to certain large contributions of property, other than cash or publicly traded securities. Additionally, the Act eliminates the statutory provision that excuses a donor from obtaining a contemporaneous written acknowledgement of a charitable gift if the donee organization files a return with the required information.

5. Split interest charitable gifts, especially lifetime charitable remainder trusts (which provide an income tax charitable deduction for the remainder interest), will continue to be used if there is no estate tax. If the estate tax is ever repealed, but the gift tax is not, charitable lead trusts, especially charitable lead annuity trusts which can be "zeroed out," will be popular.

6. High worth clients will need advice on setting up private foundations with all of their restrictions and limitations and donor advised funds.

7. Planning for charitable gifts from IRAs in lieu of minimum required distributions will continue.

J. Retirement Benefits

1. For all estate planning professionals who represent and work with executives, business owners, and self-employed professionals, planning for retirement benefits is critical.

2. Retirement benefits will be the single largest asset of many individuals. It is common for retirement benefits to have a value in the hundreds of thousands of dollars, and benefits exceeding one million dollars are by no means rare. Ownership and receipt of retirement benefits will entail significant income tax consequences even if there is no estate tax.

3. Given the complexity of retirement plans, clients need advice in navigating the distinctions between qualified and non-qualified benefits and understanding the differences between, for example, defined benefit and defined contribution plans and regular IRA's and Roth IRAs.

K. Elder Law

1. Estate planning for the elderly and incapacitated presents unique challenges. On the non-tax front, there may be questions of the individual's competence, or ability to understand the estate planning alternatives being considered. Communication may be a challenge due to physical disability. There may be questions of influence by other family members.

2. Elderly clients often have special concerns related to health care and extended care arrangements for themselves.

3. If the person is mentally incapacitated, and needs estate planning, there are both special procedures and special challenges in determining the person's presumed intent.

4. As the American population ages, more and more people will need advice on issues such as financial planning, housing, long-term care insurance, Medicare, and Medicaid.

L. Business Planning

1. Advising closely held businesses on non-tax and tax issues will continue to be important even if few people are subject to the estate tax.

2. Non-Tax Issues

a. Experts estimate that 85% of the crises faced by family businesses focus around the issue of succession. Therefore, in addition to addressing the legal aspects of passing a family business from one generation to the next, attorneys, accountants, family business consultants, trust officers, and other professionals must help families meet and overcome the conflict that will inevitably occur when a family plans for the succession of the control and/or ownership. In fact, such conflict is, in most situations, inescapable. Experts tell us that conflict is a necessary part of human relationships. Human beings are incapable of spending any significant time together without having differences.

b. Surmounting the challenges of this conflict requires both sensitivity to family dynamics and an extensive knowledge of the wide range of legal disciplines that impact succession issues.

c. Lack of Succession Planning.

(1) Despite the importance of succession planning, a 2007 survey of family businesses found that 40.3% of business owners expected to retire within 10 years.

(2) But of those business owners expecting to retire in 5 years, only about half (45.5%) had selected a successor, and of those expecting to retire in 6–11 years, only 29% had selected a successor. But 30.5% had no plans to retire, ever; and since the median age of the business owner was 51, many planned to die in office.

d. Human Planning Requirements.

(1) A business owner who fails to prepare and execute a succession plan—and especially one who dies in office—leaves his or her family, business, and wealth in a uncertain state.

(2) The business will be subject to questions about what should be done with the business, and attacks by those who wish to take control or have ownership or those who think that they are entitled to ownership and control.

3. Planners will have to advise closely-held and family-owned businesses on a variety of other issues as well, including the following:

a. Buy-Sell Agreements

b. Redemptions of Stock under Section 302 of the Internal Revenue Code

4. S Corporations. Much planning will have to be done for S Corporations. There are over 3.5 million S Corporations. Many taxpayers will want to revisit the "S Corporation versus C Corporation" analysis.

M. Trust Administration and Fiduciary Litigation

1. A doubled estate tax exemption level may mean that individuals will place more assets and funds in trust than currently, because assets will no longer be depleted to pay estate, gift, and generation-skipping transfer taxes. The more assets that are in trust, the more likely that beneficiaries will fight with themselves or contest the actions of trustees. Thus, more trusts will likely lead to more fiduciary litigation than currently.

    a. With the rise of the use of irrevocable trusts for tax and non-tax reasons, draftspersons and settlors are looking ways to provide for flexibility in these irrevocable trusts. There will be a growing need for advice on this. Methods that are used include:

        (1) Lifetime and testamentary powers of appointment.

        (2) The use of trust directors or protectors who have powers to amend the provisions of irrevocable trusts.

        (3) Trust reformations.

        (4) Non-Judicial Settlement Agreements under the Uniform Trust Code.

        (5) Trust mergers.

        (6) Trust divisions.

    b. An increase in fiduciary litigation or fiduciary disputes could lead to more work for estate planning professionals as expert witnesses, mediators, or arbitrators.

    c. In addition, an increase in the amount of assets held in trust could result in the need for more investment advice with respect to the appropriate assets to be held in particular trusts.

N. Mediation or Arbitration

1. Mediation of disputes which is non-binding or arbitration of disputes which is binding may be a way of resolving disputes involving trusts.

2. The trust instrument might simply provide that in the event of disagreement between two individuals—such as a disagreement between two trustees, or a disagreement in a valuation of trust property that might affect two beneficiaries—those individuals must submit the dispute to a third party, whose determination is binding.

O. <u>Decanting</u>. This is a technique under which a trustee of a current trust may create a new trust and transfer assets to the new trust. Given the differences between the law of the different states that permit decanting either by case law or statute, advice will be needed on decanting. The Uniform Trust Decanting Act ("UTDA") was promulgated by the Uniform Law Commission in 2015. The purpose was to provide a more complete set of rules for decanting than currently exist in any state. The UTDA has, as of January 1, 2018, been enacted in five states: Colorado, New Mexico, North Carolina, Virginia, and Washington.

1. <u>Decanting Statutes</u>. As of January 2, 2018, twenty-six states now have statutes under which a trustee, pursuant to a power to distribute trust assets outright, may appoint trust assets in favor of another trust. These states are the following:

    1. Alaska
    2. Arizona
    3. Colorado
    4. Delaware
    5. Florida
    6. Illinois
    7. Indiana
    8. Kentucky
    9. Michigan
    10. Minnesota
    11. Missouri
    12. Nevada
    13. New Hampshire
    14. New Mexico
    15. New York
    16. North Carolina
    17. Ohio
    18. Rhode Island
    19. South Carolina

20. South Dakota

21. Tennessee

22. Texas

23. Virginia

24. Washington

25. Wisconsin

26. Wyoming

II. Traditional Planning for Clients

A. Even with the doubling of the estate tax exemption, many clients will still have to engage in planning to avoid estate, gift, and generation-skipping transfer tax planning. In advising clients on planning for estate, gift, and generation-skipping transfer tax purposes, it is often best to start with the simpler techniques and move on to more complex techniques. Often, the simpler techniques produce the desired results without the need to use more sophisticated techniques. Various techniques are discussed below.

B. Annual exclusion gifts.

1. The gift tax law currently provides an exclusion from gift tax for the first $10,000 (indexed for inflation) given to any donee in any year (IRC § 2503(b)). The annual exclusion amount is indexed in $1,000 increments. The indexed amount in 2018 is $15,000.[3] Thus, in 2018, an individual to make annual gifts of up to $15,000 to any number of people, without any gift tax on the transfers. If the individual is married, the couple can each use their separate $15,000 exclusions, by either (a) using their separate funds to make gifts, or (b) using one spouse's funds and consenting to treat gifts made by the couple as being made one-half by each of the spouses (IRC § 2513).

2. The benefits that can be derived from making annual exclusion gifts should not be underestimated. In substantial estates, simple cash gifts of $15,000 made shortly before a decedent dies can generate a federal estate tax savings of up to $6,000 (or more if state estate taxes apply) for every transferee involved.

[3] Although the IRS announced a $15,000 indexed annual exclusion prior to enactment of the Act, the indexing will have to be recomputed in light of the use of the chained CPI in place of CPI-U.

EXAMPLE: Frank has extensive assets and three children (two of whom are married) and five grandchildren. If Frank has an estate that would be taxed in the 40 percent bracket (considering federal and state taxes), gifts of $15,000 to each of the three children, to the spouses of the two married children, and to each of the five grandchildren would entail transfers of $150,000. These transfers would result in an estate tax savings of $60,000. If Frank is married and his spouse joins in the gifts, an additional $150,000 (or a total of $300,000) could be transferred with no gift tax liability, and the total estate tax savings would be $120,000 per year. If Frank and his spouse continue this gift program for ten years, his taxable estate will be reduced by $3,000,000 and his estate tax would be reduced by $1,200,000.

3. By giving away property which is likely to grow in value, not only the gifted property itself, but all the future appreciation on that property can be removed from the donor's estate.

EXAMPLE: Father gives Son $30,000 worth of stock in the XYZ Widget Company. No gift tax is owed because Father splits the gift with Mother. At Father's death, the $30,000 of XYZ Widget Company stock has soared in value to $150,000. If Father at his death is in the 40% estate tax bracket, the lifetime gift of the stock to Son saves $60,000 in federal estate tax.

4. The $15,000 annual exclusion is only available for gifts of present interests. Gifts of future interests, that is, gifts in which the donee's absolute, unrestricted right to enjoyment of the property is deferred until some future time, do not qualify. This means that many gifts in trust will not qualify for the annual exclusion unless the trust is properly structured.

EXAMPLE: An individual sets up a trust for his twenty-five-year-old son which provides that the trustee has the discretionary power to distribute income and principal to the son for five years, and at the end of the five years the property will be distributed outright to the son. The gift is a future interest since the son's unrestricted right to beneficial enjoyment of the property is deferred for five years. This transfer would not be eligible for the $15,000 annual exclusion. Minor exclusion trusts and Crummey trusts can be used to qualify gifts in trust for the annual exclusion.

C. Dynasty trusts and use of GST exemption.

1. The generation-skipping transfer tax ("GST tax") has made it more difficult to plan effectively for future generations. The purpose of the GST tax is to require that estate tax (or its equivalent) be paid at each generation. When one considers the fact that the total of the estate tax on a parent's and a child's estates could consume 80% of an asset's value by the time it gets to a grandchild, this concept can be devastating to a family's wealth.

2. There is a very important exception to the GST tax. Every individual has a $10,000,000 GST exemption (adjusted for inflation) that can be used to shield transfers from the tax. A husband and wife have a combined exemption of $20,000,000 (adjusted for inflation). The ability to apply this exemption to property and have that property and all future appreciation protected from transfer tax can provide substantial benefits to future generations.

3. Individuals with significant wealth should try to take advantage of the GST exemption during life by setting aside property in an irrevocable trust for children and grandchildren. The sooner the GST exemption is used, the greater the amount of property that will be sheltered from transfer tax. With the doubling of the gift tax and GST exemptions in 2018, clients who are or may be in a taxable estate situation and who can afford to should make gifts now to take advantage of the new exemption and get the future appreciation out of their estates. This would also protect them from future changes in the estate, gift, and generation-skipping taxes. In addition, under current law, the doubled exemption will sunset as of January 1, 2026. Moreover, during the period before 2026, the control of Congress and/or the White House could change and the provisions enacted in the Act could be reversed or modified to the detriment of taxpayers.

4. An individual or couple can get a substantial head start on the use of the GST exemption with a gift using the full gift tax applicable exclusion amount.

   EXAMPLE: A husband and wife give $10,000,000 to an irrevocable trust for the benefit of their descendants and allocate their GST exemptions to the trust. If the trust assets grow on average at a 6% after tax rate (accumulated income plus appreciation) and husband and wife live for another 25 years, there will be over $42.9 million in the trust at their deaths. By creating the trust during life, the couple has set aside an additional $32.9 million that can pass tax-free to grandchildren.

5. Another way to maximize the use of the GST exemption is to create a so-called "dynasty trust" that is intended to last for the maximum period permitted by law. Under many states' laws, a dynasty trust can last for up

to 21 years after the death of the last surviving family member who was living when the trust was created (this period of time is called the "perpetuities period"). Assuming normal life expectancies, such a trust created by an individual today could be expected to last nearly 100 years. A number of states now permit perpetual trust terms, and one can take advantage of this by choosing which state's law will govern the trust. During the existence of the trust, trust property would be available to the grantor's descendants for such purposes as the grantor designates. There would be no gift, estate or GST tax assessed on the trust property during the term of the trust. Thus, the property can be insulated from transfer tax for two or three generations, and sometimes in perpetuity if desired.

> **EXAMPLE:** A husband and wife place $10,000,000 in a dynasty trust for the benefit of their descendants, and allocate their GST exemptions to the trust. The trust is to last until the end of the perpetuities period, assumed to occur in 100 years. Assuming the trust assets grow on average at a compounded 6% after tax rate and 2% per year is paid out to the beneficiaries, the assets will be worth $505 million when the trust ends in 100 years. This property will pass to their grandchildren or great-grandchildren free of transfer tax at that time.

Assume that the assets grow at the same rate but the trust is not exempt from the GST tax because no GST exemption was allocated to it. Assume that a 40% GST tax is imposed in 80 years when the grantor's last child dies. At the child's death in 80 years, the assets will have grown in value to $230.5 million. However, a GST tax of about $92.2 million will be due, leaving about $138.3 million after tax. At the end of an additional 20 years, the trust will be worth $303 million, or $202 million less than if it had initially been exempted from GST tax.

6. One variation on the use of the dynasty trust for married clients who would like to give away assets now to their children and grandchildren and others now but worry about possibly needing access to the funds later is for one spouse to create a SLAT or "Spousal Lifetime Access Trust" which is nothing more than an irrevocable trust funded with gifts using the applicable exclusion with the grantor's spouse as a discretionary beneficiary. It is also possible for each spouse to create a dynasty trust for the benefit of the other spouse and the descendants or other beneficiaries, but care needs to be taken to avoid the application of the reciprocal trust doctrine.

7. For single individuals who wish to make large gifts to a dynasty trust while retaining access to the assets in the trust, one possibility is a Domestic Asset Protection Trust under the laws of one of the eighteen states that now permit them. Several commentators have taken the

position that if creditors cannot reach the trust property, as will be the case if the Domestic Asset Protection Trust statutes prove effective, the trust property will not be includible in the settlor's gross estate, even though the settlor is a discretionary beneficiary of the trust. Instead, a completed gift will occur upon the transfer of the property to the Domestic Protection Trust. The result is a freeze transaction. The settlor would incur gift tax (or use exemption) upon funding of the trust and would continue to enjoy the property as a discretionary beneficiary of the trust; however, the trust would not be taxed in the settlor's estate under either Internal Revenue Code Sections 2036(a)(1) or 2038. The donor could use part or all of his or her $10 million gift tax applicable exclusion amount to shelter the gift from gift tax.

> **EXAMPLE:** A creates a Domestic Protection Trust in Delaware in 2018 and funds it with $10 million. This gift escapes gift tax because it is sheltered from gift tax by A's lifetime $10 million exclusion from gift tax. A and his children are discretionary beneficiaries of the trust. Because creditors cannot reach the assets in the trust, the gift is complete. A dies in 2025 when the assets in the trust are worth $ 22 million. Up until the time of his death, A has been a discretionary beneficiary and received distributions from the trust. By using a Domestic Protection Trust, according to its proponents, the $12 million of appreciation after funding of the trust will escape estate taxation.

In order to obtain this favorable tax treatment, there first must be a completed gift for purposes of Internal Revenue Code Section 2511. To have a completed gift, the settlor's creditors should not be able to look to the settlor's Domestic Protection Trust for payment of debts.[4] A gift should become complete when the period specified under the law of the jurisdiction for a creditor to reach the property in the trust ends. Note that this period is typically a few years under state law, so this technique would best be used well before 2026.

8. Advisors should also consider using outright gifts of life insurance or irrevocable life insurance trusts as a method to leverage the increased exemption to provide more for family members and others.

D. Portability of Estate Tax Applicable Exclusion Amount

[4] Comm'r v. Vander Weele, 254 F.2d 895 (6th Cir. 1958); Outwin v. Comm'r, 76 T.C. 153 (1981); Estate of Paxton v. Comm'r, 86 T.C. 785 (1986).

1. Portability of the federal exclusion provides further planning options. Using "portability," spouses can effectively combine their estate and gift tax exemptions, no matter how the assets pass upon the first spouse's death. This would enable spouses to pass a total of $20,000,000, indexed for inflation, free of estate and gift tax.

2. As an example, a couple can avoid all estate tax at the first death by passing property to the survivor in a form that qualifies for the marital deduction. The estate of the first spouse to die can elect portability, giving the survivor $11,180,000 of exclusion based on the death of the first spouse in 2018. The surviving spouse would then be able to use the unused exemption of the first spouse, either for inter vivos gifts during the life of the second spouse, or upon the second spouse's death.

3. To apply the portability rules, the legislation in 2010 introduced the term "deceased spousal unused exclusion amount," or "DSUE amount".

4. The executor of the deceased spouse's estate must elect to allow the surviving spouse to use the DSUE amount. This means that the estate of the deceased spouse will need to file an estate tax return, even if it is below the threshold for filing.

5. The DSUE amount available to the surviving spouse is limited to the lesser of the basic applicable exclusion amount and the unused exclusion amount of the last deceased spouse.

6. The DSUE amount can be used by the surviving spouse to make taxable gifts. Temporary regulations provide that a surviving spouse will be deemed to use DSUE amount first when making taxable gifts.

7. However, portability has some limitations over traditional planning that would make use of the first spouse's estate tax exemption, including the following:

   a. There is no portability of GST tax exemption.

   b. The DSUE amount is not indexed for inflation.

E. <u>Grantor Retained Annuity Trusts</u>

1. A GRAT is an irrevocable trust in which the grantor retains the right to receive a fixed dollar amount annually for a set term of years. At the end of that period, any remaining property passes as provided in the trust, either outright to designated beneficiaries or in further trust for their benefit. For a GRAT to be successful, the grantor must survive the annuity term. If the granter dies during the term, the IRS includes the entire value of the GRAT in the grantor's estate under Internal Revenue Code Section 2036 (retained interest) and Internal Revenue Code Section

2039 (right to an annuity). See, e.g., Letter Ruling 9345035 (Aug. 13, 1993).

2. The transfer of property to a GRAT constitutes a gift equal to the total value of the property transferred to the trust, less the value of the retained annuity interest. The value of the annuity interest is determined using the valuation tables under Section 7520 and the applicable interest rate for the month of the transfer. The grantor of a GRAT is treated as making an immediate gift when the trust is funded, but the value of the gift is a fraction of the total value of the property because it represents a future benefit. Therefore, if the grantor survives the annuity term, there is an opportunity for property to pass to the designated remaindermen at a reduced transfer tax value.

EXAMPLE: Mary, age 55, transfers $500,000 of assets to a GRAT and retains the right to receive an annuity of $43,750 per year, payable annually, for 12 years. Under the IRS tables, if the Section 7520 rate is 2.2%, the value of Mary's retained annuity interest is $457,039, so the amount of the gift upon creating the GRAT is $42,961. (At 3.2%, the gift is $69,666.) If the trust assets provide an average return of at least 5% annually there will be $201,555 in the trust at the end of 12 years. That property will pass to the remaindermen for an initial gift of $42,961. If the trust assets provide an average return of at least 7% annually, there will be at least $343,475 in the GRAT at the end of the term.

3. The annuity does not have to be an equal amount each year. It can be defined as a fixed initial amount, increased by up to 20% in each subsequent year.

4. Most GRATs provide that the annuity payout amount must be satisfied from trust principal to the extent trust income in a given year is insufficient. The IRS has ruled privately that Internal Revenue Code Section 677 applies where the annuity may be satisfied out of trust income or principal. See e.g., Letter Ruling 9415012 (January 13, 1994). Therefore, virtually every GRAT should be treated as a grantor trust with respect to all trust income. This is an important additional benefit. It means that a GRAT can be funded with stock or partnership interests or real estate, and that asset can be paid back to the grantor to satisfy the annuity obligation without the distribution of the asset being treated as a sale.

F. Zeroed-Out GRATS. The GRAT is particularly attractive for individuals who have used their applicable exclusion amount but still want to transfer wealth to others. A "zeroed-out GRAT" can be used so that there are no gift tax consequences to the creation of the trust. By structuring the GRAT so the value of the annuity equals the value of the property transferred, the taxpayer can avoid using applicable exclusion or paying gift tax. If the transferred assets increase significantly in value during the term of the GRAT, some of that appreciation is transferred out of the taxpayer's estate tax free.

1. Internal Revenue Code Section 2702 provides that an interest in a trust retained by the grantor will be valued at zero for purposes of determining the value of the gift to the trust, unless the retained interest is a qualified annuity interest, a qualified unitrust interest or a qualified remainder interest. The regulations under Internal Revenue Code Section 2702 provide that the term of the annuity or unitrust interest "must be for the

life of the term holder, for a specified term of years, or for the shorter (but not the longer) of those periods." Treas. Reg. § 25.2702-3(d)(3).

2. Despite the apparent statement in its own regulations granting three options for the term of a GRAT, the IRS took the position when it initially issued its final Internal Revenue Code Section 2702 regulations that an annuity payable for a term of years (with annuity payments continuing to the grantor's estate if he or she died during the term) always had to be valued as an annuity for a term of years or the prior death of the grantor.

   a. The position was not stated in the text of the final regulations; rather it was illustrated in one of the regulation's examples. See prior Treas. Reg. § 25.2702-3(e), Example 5.

   b. The requirement that one always must take into account the possibility of the grantor's death before the end of the term in valuing the annuity had the effect of reducing the value of the annuity, and increasing the value of the remainder interest and, therefore, the value of the gift for a transfer to a GRAT.

   c. Because of this and other requirements for valuing annuities, the IRS made it impossible to create an annuity in a GRAT with a value equal to the value of the property transferred.

3. In Walton v. Comm'r, 115 TC 589 (2000), the taxpayer challenged the position in the IRS regulations. The Tax Court agreed that Example 5 in the regulations is inconsistent with the purposes of the statute and declared the Example invalid.

   a. The case involved the widow of Sam Walton. In 1993, she transferred 7 million shares of Wal-Mart stock to two GRATs in which she retained an annuity of 59.22% for two years. If she died during the term, the annuity payments would continue to her estate. The GRATs failed to produce the desired benefits. The price of Wal-Mart stock remained essentially flat for two years, and all the stock was paid back to Mrs. Walton to satisfy the annuities.

   b. Mrs. Walton brought the suit to avoid a large gift tax liability for the failed transfer. Her annuity interests valued for the full two-year term resulted in a gift to the GRATs of about $6,195. If her annuity interest was valued as a right to receive payments for two years or her prior death, as the IRS asserted, the gift would be $3,821,522.

   c. The Tax Court first recognized that the IRS's regulations are entitled to considerable deference, but, as interpretative regulations, they still could be ruled invalid if they do not implement the congressional mandate in some reasonable manner.

Based on the purpose of the statute and its legislative history, the court concluded that there was no rationale for requiring that the annuity be valued as a two-year or prior death annuity. In particular, the court noted that Congress referred to the charitable remainder trust rules as a basis for the Internal Revenue Code Section 2702 provisions, and the regulations clearly allowed a two-year term to be valued without prior death contingencies in a charitable remainder annuity trust.

d. The IRS subsequently amended its regulations to specifically recognize the valuation of term interests as term interests.

4. The ruling in Walton gave taxpayers the unique opportunity to implement a technique that has no tax cost if it fails. By structuring the GRAT so the value of the annuity equals the value of the property transferred, the taxpayer can avoid using applicable exclusion or paying gift tax.

5. A zeroed-out GRAT often works best when the annuity term is short (such as two years) and the GRAT is funded with one stock. A single stock that performs well during a two-year period easily can grow at an annual rate of 20% or more over that time frame.

EXAMPLE: In February 2016 when the Section 7520 rate is 2.2%, an individual creates a two-year GRAT and funds it with $5,000,000 of stock that has a current price of $25 per share. He retains the right to receive an annuity of 51.6556% each year for the two years. The value of the annuity is $5,000,000, and the gift when the individual creates the trust is zero. If the stock increases to $30 per share after one year, and $36 per share at the end of two years (a 20% increase each year), there will be $1,517,884 left in the GRAT at the end of the two years to pass to children tax-free:

Initial Value of Stock:	$5,000,000
End Year 1 Value	$6,000,000
Annuity to Grantor:	($2,582,780)
Beginning Year 2 Value	$3,417,220
End Year 2 Value:	$4,100,664
Annuity to Grantor:	($2,582,780)
Property Remaining for Children:	$1,517,884

6. The property transferred to a two-year GRAT needs to sustain a high growth rate for only a short period of time for the GRAT to be successful. If the property does not appreciate as anticipated, it all is returned to the

grantor in the annuity payments. The grantor then can create a new GRAT.

7. If a short term GRAT is used, it is better to isolate separate stocks in separate trusts so that the losers do not pull down the winners.

8. The attributes of a zeroed-out GRAT fit well with closely held stock. The owner can use a GRAT to try to shift additional stock out of his or her estate, at no tax cost. Especially given the current Section 7520 rate, the stock does not have to grow at a tremendous rate for the GRAT to have some benefit. As long as the stock grows at a rate greater than the assumed IRS rate used in determining the gift, there will be some benefit.

> **EXAMPLE:** Mark is the owner of an increasingly successful business, Full Circuit, Inc. He has transferred some stock to his children using an irrevocable Crummey trust and has now fully used his gift tax applicable exclusion amount. After Mark funds the irrevocable trust, he transfers 4,200 of his remaining non-voting shares in Full Circuit to a 3-year GRAT. The stock is valued at $3,400 per share, so the total transfer is $14,280,000. The IRS Section 7520 rate in the month of the transfer is 3.0%. Mark retains an annuity of 29.2415% ($4,175,686) payable at the end of the first year, increased by 20% in each of years 2 and 3. The annuity has a value of $14,280,000, so no gift is made when Mark creates the GRAT. The stock increases in value to $3,600 per share after one year, $4,000 per share after two years, and $4,200 per share at the end of three years. The GRAT operates as follows:

Year-End	**Annuity Payable**	**Value Per Share**	**Shares Paid to Mark**	**Shares Remaining**
1	$4,175,686	$3,600	1,160	3,040
2	$5,010,823	$4,000	1,253	1,787
3	$6,012,988	$4,200	1,432	355

a. In this example, the GRAT removes 355 shares from Mark's estate, with a value of $1,491,000 at the end of the three-year term.

b. If the value of Full Circuit increases significantly over this time-period, the benefit of the GRAT is far greater. In effect, the GRAT allows Mark to shift most of this additional appreciation out of his estate.

> **EXAMPLE:** Assume the stock in Full Circuit increases in value by 15% in each of the first two

years and 20% in the third year after Mark creates the GRAT. The GRAT operates as follows:

Year-End	**Annuity Payable**	**Value Per Share**	**Shares Paid to Mark**	**Shares Remaining**
1	$4,175,686	$3,910	1,068	3,132
2	$5,010,823	$4,495	1,115	2,017
3	$6,012,988	$5,395	1,115	902

c. In this example, Mark has moved 902 shares out of his estate, with a value of $4,866,290 at the end of the three-year term. Overall in this example, Mark's 4,200 shares originally transferred to the GRAT are worth $5,019,000 more after three years than in the prior example. The GRAT moves 97% of his additional appreciation ($4,866,290/$5,019,000) out of Mark's estate.

9. One issue in a straight-term-of-years, or Walton, GRAT is how to minimize the estate tax consequences if the grantor dies during the annuity term.

a. In a GRAT with annuity payable for a term of years or the grantor's prior death, if the grantor is married, the trust simply can provide that all the trust property will pass to a marital trust for the surviving spouse, or will pour back into the grantor's estate plan and be allocated between the marital and nonmarital trusts.

b. If the grantor dies during the term of a term-of-years GRAT, the annuity payments do not stop at the grantor's death; they are paid to the grantor's estate (or revocable trust if so designated in the GRAT). If the goal is to preserve the marital deduction for the property, the annuity payments should be bequeathed to the spouse or a marital trust under the grantor's estate plan, and the GRAT corpus at the end of the term should be paid to the spouse or marital trust. This should allow the two property interests to be merged back together, to qualify all the property for the marital deduction.

G. The GRAT can be a particularly advantageous way to transfer stock in an S corporation. An irrevocable grantor trust is a permissible shareholder of stock in an S corporation. See, e.g., Letter Ruling 9415012 (January 13, 1994). Because the S corporation is a flow-through entity for income tax purposes, the trustee of a GRAT is able to satisfy annuity payments with pre-tax dollars from the corporation. The same benefits exist for interests in a limited partnership or LLC.

EXAMPLE: Carlos owns a 10% interest in an S Corporation that has an entity value of $27,500,000. After discounts, his interest is worth $2,000,000. He anticipates it will appreciate rapidly. Carlos transfers his $2,000,000 of S Corporation stock to a GRAT and retains an annuity of $200,000 per year for 12 years. The value of Carlos' retained annuity interest is $2,000,000, so Carlos makes no taxable gift when he creates the GRAT. The S Corporation currently distributes cash of about $200,000 per year to Carlos (about 7.2% of the initial undiscounted value) to provide funds for income taxes and some additional discretionary shareholder funds. The GRAT can pay Carlos the annuity out of the cash distribution that the GRAT receives each year, and Carlos uses a portion of the annuity distribution to pay his income taxes related to the S Corporation income. The GRAT is able to retain all of the stock. If the value of the stock increases by about 5% per year, the GRAT will have $3,600,000 in it after 12 years.

H. If voting stock in a closely held corporation (one in which the grantor and related parties own 20 percent or more of the voting stock) is transferred to the GRAT, the grantor should not retain the right to vote that stock beyond the date that is three years before the end of the annuity term. The right to vote the stock will cause the stock to be included in the grantor's estate under Internal Revenue Code Section 2036(b), and the relinquishment of that right within three years of death will cause inclusion under Section 2035(d). If the grantor retains the right to vote the stock until the end of the annuity term, he must survive an additional three years to ensure that the property will be excluded from his estate. This problem can be avoided by using non-voting stock.

I. At the end of the annuity term, the property in the GRAT can be distributed outright to the grantor's children or other beneficiaries, or retained in trust. One advantage of retaining the property in trust is that the grantor's spouse can be a beneficiary, thereby permitting the couple to have some access to the property during the spouse's life and causing the trust to continue to be a grantor trust.

J. GRATs have a significant advantage over other gifting techniques because of the ability to define the retained interest as a percentage of the initial value of the gifted property "as finally determined for federal gift tax purposes". Thus, if the gift value is doubled, so is the retained annuity, and there is little or no increase in the amount of the gift.

K. <u>Grantor Retained Unitrusts</u>

1. In some circumstances, an individual may want to consider an alternative to a GRAT called the grantor retained unitrust (GRUT). In a GRUT, the individual retains the right to an annual payment equal to a fixed percentage of the value of the trust assets, determined annually.

2. Trust distributions to the grantor under a GRUT, unlike a GRAT, can vary from year to year, depending upon the value of the trust. The unitrust may be beneficial when the grantor is concerned about protection against inflation.

3. Offsetting the potential benefits of a GRUT is the fact that it may be more difficult to administer than a GRAT because the trust assets must be revalued every year to calculate the distributable amount, and enough cash must be available to make any increased payments. This may be burdensome, especially if closely held stock is used to fund the trust. Increases in the value of closely held stock will require the GRUT to increase its payments even though it may not receive more income from the stock.

4. In addition, because the grantor under a GRUT will recover part of any appreciation and accumulated income in the trust, a GRUT often will leave the remainder beneficiaries economically worse off than if a GRAT were used.

5. It is also not possible to do a "zeroed-out GRUT" as it is possible to do a "zeroed-out GRAT." Planners therefore should carefully compare these two techniques before implementing one of them.

L. <u>Charitable Lead Trusts</u>

1. A charitable lead trust, or CLT, is sometimes used to try to accomplish the same benefits as a GRAT in situations where the client has a strong interest in also benefiting charity. With a CLT, the charitable beneficiaries receive a stated amount each year for a specified term of years or for the life or lives of an individual or individuals, and at the end of the period the remaining corpus is distributed to or in trust for the grantor's descendants or other noncharitable beneficiaries.

2. As with charitable remainder trusts, lead trusts may be one of two types--either an annuity trust ("CLAT"), in which the charitable beneficiary receives a sum certain, or a unitrust ("CLUT"), in which the charity receives a fixed percentage of the value of the trust property. The lead trust is very flexible; it may allow the trustee discretion in determining which charities will receive payments, or it can provide for specific charities. Unlike a charitable remainder trust, there is no minimum payout for a charitable lead trust, and it can be for any term of years. The trust may be created irrevocably during life or at death.

3. Upon creating the trust, the grantor makes a gift to charity of the present value of the charity's right to receive trust payments. This gift qualifies for the federal gift tax charitable deduction. Generally, when the grantor creates the trust, he will not receive an income tax charitable deduction.

a. One exception is where the CLT is a grantor trust, in which the trust income is taxable to the grantor under the applicable income tax rules. In this case, the grantor is entitled to claim an income tax charitable deduction in the taxable year in which the trust is created for the present value of the annuity interest.

b. The deduction will, however, be subject to a limitation of 30 percent of the grantor's contribution base (20 percent if long-term capital gain property is used to fund the trust) because contributions to a charitable lead trust are treated as "for the use of" the charitable donees. Treas. Reg. § 1.170A-8(a)(2).

c. In addition, the income of the trust in the years after its creation will be taxable to the grantor, with no further charitable deduction allowed, even though the trust actually distributes the income to charity.

4. If the CLT is not a grantor trust, the grantor will not receive any income tax charitable deduction for the amounts paid to charity, either when the trust is created or subsequently. However, the income generated by the trust's assets will be removed from the grantor's gross income. Thus, the income tax effect on the grantor will be equivalent to his receiving an income tax charitable deduction each year, but without the applicable percentage limitations for contributions.

5. A charitable non-grantor lead trust is not exempt from taxation, and the trustee must file a fiduciary income tax return (Form 1041) each year. However, the trust's taxable income should be low or nil in most cases, since the trust will receive a charitable deduction for the payments made to charity. IRC § 642(c)(1). Any income the trust earns in excess of the yearly annuity amount will be taxed to the trust at its separate rates.

6. The trust will be entitled to a charitable deduction only for amounts paid for charitable purposes from gross income. IRC § 642(c)(1). To maximize the trust's income tax charitable deduction, therefore, the charitable payments should be made as much as possible from trust income, before trust principal is used.

7. Lifetime Transfer Tax Planning Opportunities

a. A grantor CLT may be attractive because it allows the donor to claim a large up-front charitable income tax deduction, with the prospect for some transfer tax benefits at the end of the charitable term, as described below. An individual who has a significant income event in one year may be interested in a grantor CLT.

b. The primary appeal of a CLT is the potential transfer tax benefit that can be obtained while fulfilling pre-existing charitable giving goals. A CLAT can be structured so that the value of the remainder interest is zero like a zeroed-out GRAT.

> **EXAMPLE:** If an individual transfers $1,000,000 to a CLAT to pay one or more charities a $83,770 annuity each year for 15 years, and the Section 7520 rate at the time is 3%, the annuity interest will be valued at $1,000,000 for gift tax purposes, and the trust remainder will be zero. If the trust earns 5%, then $271,290 will remain at the end of the term and will pass to the remainder beneficiary at the end of the annuity term free of gift tax. If the trust earns 7% annually, almost $654,000 will remain after 15 years.

8. Testamentary Tax Planning Opportunities

   a. In addition to an inter vivos transfer, one can create a CLT to take effect at death. A testamentary CLT can be used to reduce federal estate tax that otherwise will occur at the testator's death. The testator's estate may claim a federal estate tax deduction for the value of the charitable interest, and, as is true of the inter vivos transfer, only the remainder will be subject to transfer tax.

   b. The testamentary CLT provides no income tax benefit to the testator or the noncharitable beneficiaries. While it can be used to reduce the estate tax cost of transferring assets to those beneficiaries at death, this fact does not necessarily leave those beneficiaries better off than if the trust assets passed directly to them at the decedent's death with no charitable deduction. This is because use of a CLT postpones the time at which the noncharitable beneficiaries come into possession of the trust assets. The lost use of the trust assets by those beneficiaries during the charitable term is a significant detriment, which can outweigh the estate tax savings from using the trust.

      (1) For example, assume Decedent A leaves $2 million in a trust for descendants. It accumulates income for 20 years and then distributes to descendants. Its total return during the period averages 6% per year. After 20 years, the trust has $5,971,968.

      (2) Decedent B leaves $5,425,000 in a CLUT that pays a 5% unitrust amount to charity for 20 years, and then distributes to descendants. The value of remainder interest in B's estate is $2 million. The trust earns 6% per year on average. After 20 years, the trust has $6,425,600.

(3) Because the return on the trust property exceeded the 5% payout rate, more property accumulated for the children through use of the CLUT. However, the difference is not significant, and it is at a cost of deferring any access to the property for 20 years. (With an ordinary trust for descendants, discretionary distributions could be made during the 20-year period.) If the trust property earned only 4% per year on average, the trust for descendants would have \$4,382,200 after 20 years, and the CLUT would have only \$4,348,360.

c. An individual considering a testamentary CLT may be willing to accept this possible detriment to his family because of his or her significant charitable intentions, and if the trust serves the additional purpose of reducing the chance that the IRS will challenge valuations in the estate. It is possible to couple a testamentary CLT with a residuary bequest that caps the taxable value of the estate (often called a "charitable cap").

(1) For example, an individual could have a residuary provision, after various specific bequests to individuals and trusts for family, that states that the trustee will allocate the remaining trust principal to a charitable lead annuity trust or unitrust with a 15-year term and the minimum payout rate necessary so that the taxable value of the disposition does not exceed \$10 million.

(2) If the residuary assets are valued at \$30 million, a CLUT would need to have a unitrust payment of 7.26%. The CLUT would make charitable payments starting at about \$2,178,000 per year. After 15 years, the property would pass to descendants or trusts for their benefit. Even if the CLUT averages a return of only 4% per year, there still would be \$17,840,000 remaining at 15 years. If the average investment return was 8%, the CLUT would have over \$32 million after 15 years.

(3) If the IRS challenged the value of certain assets in the individual's estate, the change in value only would alter the percentage payout on the CLUT. For example, if the IRS claimed the estate was worth another \$5 million, the CLUT payout rate would adjust to 8.234%, and the taxable value would remain at \$10 million. The IRS loses all incentive to challenge valuations.

M. <u>Generation-Skipping Tax Planning With CLTs</u>

1. The goal of many clients is to pack as much property into a trust as is permitted within the confines of their available GST exemptions. For these clients, the use of lifetime gifts to start GST exempt trusts growing immediately is only a starting point.

2. Leveraging GST Exemption With CLT

a. Because the value of a charitable interest can be deducted from the denominator of the applicable fraction that applies to a trust under chapter 13 of the Internal Revenue Code, it clearly was possible under the original chapter 13 provisions to "leverage" the use of a transferor's GST exemption by creating a CLT.

b. Congress partially closed this perceived loophole by enacting special rules for calculating the applicable fraction for CLATs, effective for trusts created after October 13, 1987.

(1) Internal Revenue Code Section 2642(e) provides that the applicable fraction for a CLAT shall be a fraction whose numerator is the "adjusted GST exemption" and whose denominator is the value of the trust property immediately after the termination of the charitable interest.

(2) The "adjusted GST exemption" is defined as an amount equal to the GST exemption allocated to the trust when it is created, compounded annually over the charitable term at the interest rate used to determine the value of the charitable interest under the applicable valuation tables.

> **EXAMPLE:** An individual creates a $1 million CLAT trust to pay an annual annuity of $80,000 to charity for 10 years, and to pay the trust principal remaining at the end of that period to his grandchildren. Assume that the Section 7520 rate used to value the transfer is 4%. Under the valuation tables, the gift tax value of the charitable gift is $648,870, and the gift tax value of the remainder is $351,130. If the individual allocates $351,130 of GST exemption to the trust, the adjusted GST exemption at the end of the annuity term would be $519,760 ($351,130 compounded at 4% annually for 10 years).

If the value of the trust principal at the end of the charitable term does not exceed the adjusted GST exemption, the trust will be entirely sheltered from GST tax, and there will be no tax when the property passes to the grandchildren.

However, if the trust principal has remained at $1 million, or has appreciated to a greater amount, then the trust will not be entirely GST exempt. If the individual is still living at that time and has sufficient additional GST exemption left, he could make an additional allocation of GST exemption to the trust and avoid the shortfall. Otherwise, GST tax will be incurred when the charitable term expires.

(3) If the trust principal is worth less than the adjusted GST exemption when the charitable term expires, then the transferor will have allocated too much GST exemption to the trust. There is no way to recover any excess exemption allocated to the trust in such a case. Treas. Reg. § 26.2642-3(b).

(4) The GST regulations provide that formula allocations made with respect to CLATs are not valid except to the extent they are dependent on values as finally determined for federal transfer tax purposes. Treas. Reg. § 26.2632-1(b)(2). This would appear to foreclose the possibility of using a formula that provides that the creator of the charitable lead annuity trust is allocating the least amount of GST exemption necessary to give the trust a zero inclusion ratio.

(5) As a result, determining the amount of GST exemption to allocate to a CLAT in many cases may become a guessing game. However, if the value of the trust principal at the end of the charitable term can be reasonably ascertained at the time the trust is established, it should be possible to make the correct allocation of GST exemption to the trust at the outset, and properly leverage the exemption.

> **EXAMPLE:** An individual purchases a ten-year bond with a face value at maturity of $1 million and an annual coupon rate of 5%, and transfers the bond to a new, ten-year CLAT. The interests transferred are valued using a 4% interest rate. The trust will pay an annual annuity of $50,000 to charity, and will pass to the individual's grandchild at the end of the annuity term. If the individual allocated $675,564 of GST exemption to the trust (representing the present value of $1 million in ten years discounted at 4%), the adjusted GST exemption will be $1 million at the end of

the charitable term, and the trust should be completely sheltered from GST tax.

c. CLUTs are not affected by Internal Revenue Code Section 2642(e), and the general rules under Internal Revenue Code Section 2642(a) continue to apply to them. This means that it is possible to leverage GST exemption against the remainder interest in a CLUT as before to produce an inclusion ratio of zero.

N. Sale of Remainder Interest in a GRAT or CLAT

1. An individual can avoid the ETIP rules or CLAT rules by setting up a GRAT or CLAT to permit a sale of a remainder interest in the trust to another trust that is already exempt from generation-skipping tax. For example, a GRAT could be drafted to vest the remainder interest in the grantor's children. It also could allow for the transfer of the interests to a third party (that is, no spendthrift restriction). Upon formation of the GRAT, the remainder interest would have a relatively low value. The children then could sell that interest to a previously created irrevocable trust for the grantor's descendants that is exempt from GST tax. When the GRAT terminates, the remaining trust property will be distributed to the exempt trust.

> **EXAMPLE:** P funds a 15-year GRAT with $2,000,000 of property and retains an annuity of $200,000 per year. The value of the gift of the remainder interest under the IRS valuation tables is $300,000. The GRAT provides that at the end of the term, if P is living, the GRAT property will be distributed in equal shares to P's three children, and any deceased child's share is payable to the child's estate. P's husband predeceased P and a $1,000,000 GST trust was created at his death. Shortly after the GRAT is created, the trustees of the GST trust purchase the remainder interest in the GRAT from the children for $300,000. At the end of 15 years, the GST trust receives the remaining assets of the GRAT, which should be fully GST exempt because they were acquired for full and adequate consideration.

2. The sale of a remainder interest in a GRAT or a CLAT may have income tax consequence to the selling remaindermen. The GRAT or CLAT will have a uniform basis in the transferred property equal to the basis in the hands of the grantor (adjusted for gift tax paid, if any). The remaindermen are treated as having a proportionate share of that basis for the purpose of determining gain if the remainder interest is sold.

> **EXAMPLE:** Assume the $2,000,000 of assets transferred to the GRAT have an aggregate basis of $1,000,000. The

remainder interest represents about 15% of the value in the trust ($300,000/$2,000,000) so the remaindermen have 15% of the basis, or $150,000. If the children sell the remainder interest in the GRAT to a GST trust, they would recognize gain of $150,000 ($300,000-$150,000).

If the GRAT is funded with cash, and the remainder interest is sold shortly after the trust is funded, the remaindermen should recognize little or no gain.

3. The GST trust that acquired the remainder interest takes a basis in it equal to what it paid. For instance, the GST trust in the example above will have a basis in the remainder interest of $300,000.

    a. When the GRAT terminates, the GST trust probably should take a basis in the assets it receives equal to its basis in the remainder interest. It thereafter would recognize gain (or loss) as assets are sold. Therefore, there is an income tax detriment to this technique.

    b. If the distribution upon termination of the GRAT is in the form of cash, the GST trust probably would recognize gain immediately to the extent the cash exceeded its basis.

4. One risk inherent in this transaction, if it is done with a GRAT, is that the grantor may die during the annuity term. If this occurs, the GRAT property will be included in the grantor's estate. Some GRATs are drafted to provide a reversion back to the grantor's estate in this case.

    a. If a sale of the remainder interest in the GRAT is contemplated, the planner should consider not having a reversion in the GRAT. A reversion would result in the GST trust receiving no property if the grantor dies during the term.

    b. Even without a reversion, it is not clear how the IRS would treat inclusion of the GRAT property in the grantor's estate. The IRS could view it as a new transfer and take the position that the property passing to the GST trust from the GRAT is not GST exempt, even though it was purchased with GST exempt assets.

O. <u>Gift of Remainder Interest in a GRAT or CLAT</u>

1. As described above, two of the drawbacks of a sale of remainder interest in a CLAT or GRAT are the possible capital gain incurred at the time of the sale and the limited tax basis that the purchasing trust may have in assets received as a result of buying the remainder interest.

2. To avoid these income tax consequences, the holders of the remainder interest could make a gift of the remainder interest rather than selling it.

EXAMPLE: P funds a 15-year GRAT with $2,000,000 of property and retains an annuity of $200,000 per year. The value of the gift of the remainder interest under the IRS valuation tables is $300,000. The GRAT provides that at the end of the term, if P is living, the GRAT property will be distributed in equal shares to P's three children, and any deceased child's share is payable to the child's estate. Each child makes a gift of his or her share of the remainder interest to an irrevocable trust created by the child. Each gift uses $100,000 of the child applicable exclusion amount. The child allocates $100,000 of GST exemption to the trust. If, at the end of the 15-year term, the GRAT property is worth $1,800,000, each child's trust would receive $600,000 of assets.

3. In this example, a child is the transferor of the remainder interest in the GRAT. The remainder interest is not ETIP as to that child, because no part of the remainder interest would be included in the child's estate once he or she transfers it to the irrevocable trust. Therefore, the child should be able to allocate GST exemption to the remainder interest.

4. The planning goal in this alternative is to push the property down to grandchildren or more remote descendants of the grantor of the GRAT. A child of the grantor cannot have an interest in the irrevocable trust to which he or she gives the remainder interest. However, the child's spouse could be a discretionary beneficiary of the trust. In addition, it should be possible for the child to make a gift of less than all of his or her remainder interest. For example, the child could give one-half of the remainder interest to the irrevocable trust and retain the other one-half.

5. A gift of a remainder interest in a GRAT does entail the same risks and uncertainties as a sale should the grantor die during the GRAT term. The GRAT should not provide for a reversion to the grantor in that case, for it would cause the child to waste both applicable exclusion amount and GST exemption. In addition, there is the risk that the IRS could view inclusion in the grantor's estate as a new transfer of the remainder interest and treat the property passing to the child's irrevocable trust as not GST exempt.

6. In Letter Ruling 200107015 (February 16, 2001), the IRS recharacterized a transaction involving a gift of a remainder interest and treated some of the property at the end of the annuity term as not GST exempt.

    a. In that ruling, the taxpayer proposed that an existing CLAT be modified pursuant to a special reserved power in the instrument to give one remainder beneficiary a vested remainder interest. The child who was the remainder beneficiary then proposed to make a gift of his remainder interest to his children.

b. The IRS stated that these acts would unfairly circumvent congressional intent in limiting the ability of taxpayers to allocate GST exemption to a CLAT. Therefore, the IRS ruled that it would treat only the current value of the remainder interest as being transferred by the child. All other property passing to the child's children on termination of the annuity term would be treated as a generation-skipping transfer by the original grantor.

c. There is no regulatory or statutory authority to suggest that a remainder interest that is a separately alienable property interest should be valued differently for generation-skipping tax purposes than for gift tax purposes when the child transfers it.

d. It is especially difficult to defend the IRS's position if the child sells the remainder interest rather than transfers it by gift. In that case, the generation-skipping trust acquires the asset for full and adequate consideration, as determined under the IRS's own valuation tables and statutory requirements. If a child receives an asset at the termination of a trust, and then transfers it to a grandchild pursuant to a pre-existing contractual obligation, entered into for full and adequate consideration, there appears to be no legal justification for recharacterizing the transfer as coming from the child's parent.

P. <u>Sale to "Intentionally Defective" Grantor Trust</u>

1. The sale to an "Intentionally Defective" Grantor Trust (that is a trust purposefully made a grantor trust) combines the long-recognized advantages of a sale in exchange for a promissory note with the benefits of a grantor trust.

a. An installment sale involves the sale of a business interest or other assets by an individual to the business or a third party in exchange for an installment obligation (e.g., a promissory note). The sale limits the value of the individual's retained interest to the amount of any down payment plus the face value of the note (or other evidence of indebtedness) received, reduced by the income tax liability on the payments made to him. A market rate of interest must be paid on the installment obligation in order to avoid having the face value of the note discounted for tax purposes and a gift imputed. However, the AFR should be considered a market rate for this purpose, for the reasons previously discussed. This is advantageous to the taxpayer since the AFR is usually lower than commercial lending rates.

b. Any gain from an installment sale of an asset is generally reportable on a proportionate basis over the time period in which the payments are actually received, unless the individual elects otherwise. IRC § 453. Thus, income tax resulting from the gain can be deferred and spread over more than one year. Exceptions exist, such as if the property is sold within a certain period (generally two years) or if the repayment obligation is forgiven. If the individual dies before the obligation is paid in full, any unpaid principal balance is included in his estate, and the deferred gain is taxed as payments under the note and received by his beneficiaries. Finally, if the installment obligation is transferred by bequest or inheritance to the obligor or is canceled by the deceased seller's executor, the seller's estate will recognize any unreported gain. IRC § 453B.

c. Under Internal Revenue Code Section 453A, an interest charge is imposed on the capital gains tax deferred under such installment obligations to the extent the amount of such obligations held by the taxpayer resulting from sales in a single year have an aggregate face value which exceeds $5 million. The interest rate is the rate charged by the IRS for underpayment of tax.

2. The income tax detriment of the capital gain and the Internal Revenue Code Section 453A interest charge are often acceptable costs and an installment sale directly to children or to a non-grantor trust still makes sense. However, in most estate planning motivated transactions, the installment sale is made to an irrevocable grantor trust. The trust is not treated as a separate taxpayer for income tax purposes. As a result, the transaction is not treated as a sale for tax purposes and the resulting capital gain from the sale, and the interest charges, are eliminated.

> **EXAMPLE:** Carl creates an irrevocable gift trust and funds it with a gift of $1,000,000. The trust is structured as a grantor trust. Carl then sells a $5,000,000 asset to the trust for a 15-year installment note, bearing an interest rate of 2.62% (the February 2016 long-term AFR) with a balloon payment due at the end of the term. The trust asset produces a return of about 5% per year. The trust pays the interest of $131,000 each year. At the end of 15 years, the trust will have a value of $9,659,930, or $4,659,930 after repayment of the note.

3. There are several risks inherent in the sale to an IDGT:

a. Valuation of the property sold. If the property is undervalued, the IRS can assert that the transfer was in part a gift.

b. Valuation of the note. If the note itself, or the overall transaction, is not properly structured and lacks arm's length characteristics, the IRS can take the position that the note is not adequate consideration, resulting in a gift and possibly even Section 2036 issues.

c. The income tax treatment of the sale at the death of the grantor is uncertain.

d. The assets transferred in the sale may perform poorly or the note is difficult to repay for other reasons.

4. Valuation of the property sold. In a sale transaction, the asset being sold usually will not be publicly-traded and therefore will be subject to valuation uncertainties.

a. The first step in avoiding a gift due to IRS revaluation of the property is to obtain a well-written appraisal of the asset and any applicable valuation discounts.

b. The appraisal also will help satisfy the requirements for adequate disclosure of the transfer and start the statute of limitations running if the sale is disclosed on a gift tax return. See Treas. Reg. § 301.6501(o)-1(f).

c. It generally is advisable to disclose sales on a gift tax return in order to obtain the benefit of the gift tax statute of limitations.

d. The IRS has made changes to the Form 706 that encourage this strategy, even though the taxpayer is not required to report the transaction. Part 4–General Information of the Form 706 includes the following question:

"12e Did the decedent at any time during his or her lifetime transfer or sell an interest in a partnership, limited liability company, or closely held corporation to a trust described in question 12a or 12b?" [covering any trusts created by the decedent during his or her lifetime and any trusts not created by the decedent under which the decedent possessed any power, beneficial interest or trusteeship]

5. The next logical step in minimizing valuation risk is to build into the transaction some form of adjustment clause that resets the transaction terms in response to changes in the value of the asset. The ability to use an adjustment provision has been a rapidly evolving area of the law in the past twelve years. The latest Tax Court case, Wandry v. Comm'r, TC Memo 2012-88, upheld the use of a defined value clause.

a. In Wandry, the taxpayer used a simple formula transfer clause:

"I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC … so that the fair market value of such units for federal gift tax purposes shall be as follows: … Kenneth D. Wandry … $261,000 …"

A list of donees and gift amounts followed.

b. For example, a gift of $15,000 worth of LP units in XYZ Family Partnership is a Wandry clause. It refers to the amount being given, not the number of units. In describing how the clause works, many practitioners have used the analogy of going to the gas station and asking to buy $20 worth of gas.

c. The court rejected the application of the public policy reasoning of Procter and concluded that the parents made gifts of specific dollar values of units. The court made a distinction between a formula clause that might result in a later adjustment and a savings clause that sought to unwind or adjust gifts that were of a fixed number of shares or units.

d. It also did not find the presence of a charitable donee to be a necessary prerequisite to supporting a formula clause.

6. The assignment forms in Wandry provided that each donor intended to have a good faith determination of the value made by an independent third party professional. The number of units transferred would be based on that appraisal. If the IRS challenged the valuation and a final determination of a different value was made by the IRS or a court, the number of gifted units was to be adjusted accordingly so that the value of units given to each person equaled the dollar amount specified in the assignment. The assignments specifically stated that the formula was to work in "the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law."

a. The gift tax return described the gifts to the children and grandchildren in terms of percentages of membership interest in the LLC. These percentages were derived from the value determined by an independent appraiser. The IRS claimed that the gifts of 2.39% interests to each child and a .101% interest to each grandchild saying that the membership interest should have been valued at a higher amount. The IRS and the taxpayers agreed that the 2.39% and the .101% LLC membership interests were worth $315,000 and $13,346. The IRS argued that the formula did not work to reduce the amount transferred, as the taxpayers claimed.

b. The court noted that in <u>Estate of Petter</u>, it had examined the difference between savings clauses, which had been rejected by <u>Comm'r v Proctor</u> and which a taxpayer may not use to avoid the gift tax, and a formula clause, which is valid. A savings clause is void because it creates a donor that tries to take the property back. A formula clause is valid because it merely transfers a "fixed set of rights with uncertain value." The difference, according to court, depends on an understanding of exactly what the donor is trying to give away.

c. In this case, the donees were entitled to receive predefined interests which were essentially expressed as a mathematical formula in which the one unknown was the value of an LLC unit at the time the transfer documents were executed. However, though the value per unit was unknown, the gift value was a constant. The court noted that absent the audit, the donees might never have received the proper LLC percentage interests to which they were entitled. That did not mean that parts of petitioners' transfers depended upon an audit. Instead an audit merely ensured that the children and grandchildren would receive the interest that they were always entitled to receive.

d. The court said that it was "inconsequential" that the adjustment clause reallocates membership units among petitioners and the donee rather than a charitable organization as in prior cases such as <u>Christensen</u> and <u>Petter</u>. In the court's view the gift documents did not allow petitioners to take property back. Rather the gift documents corrected the allocation of the membership units among donors and donees because the independent appraiser's report understated the value. As a result, the assignments contained valid formula clauses.

e. The court also rejected the public policy concerns expressed in <u>Proctor</u>. It stated that there is no well-established public policy against formula clauses. The role of the IRS is to enforce the tax laws, not to maximize tax receipts.

7. The <u>Wandry</u> case is a major development in establishing the validity of defined value clauses. But it is only a Tax Court Memorandum opinion, so its precedential value is limited.

a. The IRS initially filed a Notice of Appeal in the case but then dropped the appeal. The appeal would have gone to the Tenth Circuit, which is where one of the few pro-taxpayer savings clause cases was decided, under <u>King v United States</u>.

b. The Service published a non-acquiescence to Wandry in IRB 2012-46. Thus, it appears that the IRS is waiting for a more favorable opportunity to challenge the case.

c. In certain respects, it does seem that Wandry is contrary to the Proctor line of cases. The IRS certainly will argue that a defined value clause results in the donor taking property back and that this is a condition subsequent of the type prohibited in Proctor.

d. However, the IRS must overcome the many circumstances in which it has either directly sanctioned, or declined to challenge, formula clauses. Formula disclaimers, formula marital deduction provisions, formula GST exemption allocations, formula annuity provisions in GRATs and charitable split-interest trusts are common.

8. If a taxpayer uses a Wandry-type clause, the gift tax return should describe the gift as a dollar amount not a specific number of shares or units, or percentage interest. The taxpayer in Wandry did not do this, and this oversight gave the IRS its most powerful argument.

a. In order to satisfy the adequate disclosure rules, it still probably is necessary to identify the number of shares or units that the taxpayer is claiming to have transferred.

b. This can be done by describing the gift first as a dollar amount but with an additional explanation: "The taxpayer transferred \$2,500,000 of her interest in Dough Family Limited Partnership. Based on the appraisal by Honest Lee Valuation Group, the amount transferred equated to a 2.5% interest in the Partnership. However, the amount the taxpayer transferred a fixed dollar amount of limited partner interest, and the percentage interest will be adjusted if there is a final determination of a different value, so that the value of the interest transferred equals \$2,500,000."

9. Valuation and attributes of the promissory note. If the note is not given arm's length attributes, or the trust that is purchaser of the asset does not have sufficient independent assets, the IRS could argue the note has a value that is less than face value. This would result in a gift.

a. As noted earlier, the IRS would need to overcome regulatory presumptions about the face value of the note, but that is not insurmountable if the taxpayers structure the transaction in a manner that would never be done in arm's length transactions.

b. In the alternative, the IRS could claim the note is not really debt, and if the grantor dies while the note is outstanding, it could treat the transfer as a gift with retained interest in the trust, resulting in application of Internal Revenue Code Section 2036.

c. Many tax professionals recommend that the trust should be separately funded with assets having a value equal to at least 10% of the purchase price in the installment sale, in order to minimize the likelihood of the IRS claiming a gift occurs. See Letter Ruling 9535026, where the IRS suggested that a minimum of 10% equity in the trust would give validity to the transaction.

d. This creates a possible limit on the size of the transaction. If a client wants to sell a $30 million interest in a company to a grantor trust, he arguably should first fund the trust with a gift of $3 million. The client may not have that much exclusion remaining.

e. Some practitioners use guarantees to support the legitimacy of the transaction and the value of the note. For example, a child with financial resources who is a beneficiary of the trust that acquires the asset could guarantee payment of the note to the trust.

   (1) In some cases, a guarantee is used instead of seed money.

   (2) More frequently, it is used to support the seed gift, or where the grantor does not have enough gift exclusion remaining to provide an adequate seed gift.

f. There is virtually no guidance on whether the IRS will treat guarantees as effective, and on the tax consequences, if any, when the parties create a guarantee.

   (1) Many practitioners who use guarantees advise that the trust should pay the guarantor a fee for providing the guarantee. This is in response to Letter Ruling 9113009, where the IRS ruled that the agreement to provide a guarantee constituted a gift to the benefited party if there was no consideration. The IRS later withdrew this ruling (see Letter Ruling 9409018) but it nevertheless reflects possible IRS thinking on the subject.

   (2) In addition, practitioners may recommend that the trust use an independent trustee to negotiate the guarantee and fee, and/or that the fee to be paid be determined by an independent appraiser. It only makes sense to consider these alternatives in a very large transaction, given the additional costs they entail.

g. Some transactions do rely entirely on a guarantee to support the debt issued. One technique used by some attorneys is the "beneficiary defective trust," also referred to as the "beneficiary irrevocable grantor trust" and discussed later in this outline. It is an irrevocable trust funded with annual exclusion gifts subject to Crummey rights of withdrawal. The Crummey rights make the beneficiary the beneficiary the grantor of the trust for income tax purposes pursuant to Internal Revenue Code Section 678. After the trust is seeded with some annual exclusion gifts, the beneficiary then sells an asset to the trust. In this scenario, the initial gift is far less than 10% of the value of the asset sold. The transaction uses the guarantee for economic substance.

h. There are no cases or rulings that examine the use of a guarantee in the context of a sale to an IDGT. There will be situations in which the use of a guarantee is the best, or maybe only option, for providing economic substance to a transaction. It can increase the cost and complexity, and given the uncertainty of the Service's position, it clearly adds risk.

10. <u>Income tax consequences of death of grantor</u>. If the grantor dies while the note is outstanding, the IRS could treat the conversion of the trust to a non-grantor trust as a taxable event.

a. There is authority supporting the conclusion that the grantor's death is a taxable event for income tax purposes. In effect, there is a new exchange upon termination of grantor trust status, in which the property is transferred to a non-grantor trust equal to the value of the principal amount of the note outstanding. This conclusion is based on the authority that treats a termination of grantor trust status during the grantor's life as a taxable event. <u>See</u> Treas. Reg. § 1.1001-2(c), Example 5; <u>Madorin v. Comm'r</u>, 84 TC 667 (1985); Rev. Rul. 77-402, 1977-2 CB 222.

b. Some commentators have asserted that the death of the grantor should not be treated as a taxable event. They have noted that the existing legal authority addresses only events during the life of a taxpayer that result in the end to grantor trust status in the case of a trust, or to disregarded entity status in the case of entities other than trusts.

(1) For example, Treas. Reg. § 1.1001-2(e), example 5, involves a taxpayer who transfers an asset subject to a liability to a grantor trust and who subsequently renounces the power that causes grantor trust status. The example concludes that a sale is deemed to occur when the power is renounced.

(2) The commentators make the case that a testamentary transfer is different, and is subject to the overriding rule in the Code that testamentary transfers are not subject to capital gain. For an extensive discussion of this issue, see Blattmachr, Gans, and Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reasons of the Grantor's Death", 97 J Tax'n 149 (Sept. 2002) (hereafter "Income Tax Effects of Termination").

(3) The authors go further in "Income Tax Effects of Termination", and assert that the death of the grantor, and deemed change of ownership for income tax purposes that results, gives rise to a step-up in basis for the grantor trust's assets. Their argument is that the change in income tax ownership is, for income tax purposes, the receipt of property from a decedent under Internal Revenue Section 1014.

(4) The IRS has not yet confronted these questions. Its 2015-2016 Priority Guidance Plan for the first time identified a project to promulgate guidance on the basis of grantor trust assets at death under Internal Revenue Code Section 1014.

(5) Until taxpayers receive some guidance, they are left with the possibility that the death of the grantor while the note is outstanding could trigger capital gain.

(6) It is clear that regardless of the treatment of the transaction from capital gain purposes, interest payments made after the death of the grantor will be taxable to the recipient.

c. The risk of a taxable event at the death of the grantor can be avoided if the note is fully paid during the grantor's life. An extremely long-term note or a note with a balloon principal payment is less likely to be paid in full while the grantor is alive. This of course means that the risk of confronting one of these tax issues is greater.

d. It also may be advisable to have a plan to pay off the installment note if the grantor's death appears imminent. For example, the grantor and the trust could take whatever preliminary steps are necessary to line up temporary financing from a bank or other commercial lender. If the grantor is near death, the trust could borrow from the bank and pay off the installment note. After the grantor's death, the grantor's estate could lend the money back to the trust in order to re-institute the private financing, and the trust would pay off the loan from the bank.

11. Note repayment issues. The final major issue inherent in a sale to an IDGT is how the trust will repay the note. Ideally, either the property already in the trust or the property sold to the trust should produce a cash flow in some manner in order to make payments on the note.

   a. It is preferable if interest can be paid annually on the note. The payment of interest is not necessary to avoid the income tax provisions in the imputed interest rules of Internal Revenue Code Section 7872, since the interest is not being paid to a separate taxpayer. The failure to provide for interest would discount the value of the note substantially, however. If the interest required by the note is not paid, and the prospects for payment based on the nature of the asset are poor, the IRS could claim the parties knew that interest would not be paid when they entered into the transaction, and try to discount the note on that basis.

   b. If the asset sold is illiquid and not income producing, it is possible for the trust to make the installment payments, including the interest, by distributing assets in-kind to the grantor. Because the trust is a grantor trust, payment in-kind can be done without income tax consequences to either the trust or the grantor. However, if this is done on a consistent basis, it could increase the risk that the IRS would try to apply Internal Revenue Code Section 2036 to the transaction, or otherwise try to collapse it. The IRS would argue that the grantor never really completely transferred ownership of the property if it was clear from the beginning that the trust would have to use the property itself to make interest payments.

   c. Ultimately, the principal balance of the note also must be paid or discharged in some manner. This is often done by having the trust purchase an insurance policy on the grantor's life.

   d. The grantor must also assess the risk that the asset transferred may decrease in value. If the grantor made a large gift to the trust, both those assets and the assets sold to the trust could be used to repay the note. The grantor does not get back the exclusion used for the gift if this occurs.

Q. Self-Canceling Installment Notes (SCINs). A SCIN—a note having a fixed term but which terminates by its terms at the seller's death—is a hybrid using the installment approach to determine the maximum payments to be made by the buyer and using the private annuity approach (discussed later in these materials) on cessation of payments if the seller dies before all payments have been made.

1. The seller in a SCIN transaction can enjoy the same potential estate and gift tax savings as the transferor in a private annuity. The SCIN can be

used to shift excess appreciation to the heirs of the seller. If the seller dies before the end of the term of the note, the SCIN can produce significant estate tax savings.

> **EXAMPLE:** Mother, age 60, sells property worth $2 million to her daughter for a 10-year SCIN. Daughter agrees to pay mother $300,000 a year for 10 years, which reflects the $2 million value with an interest rate premium for the self-canceling feature. Mother dies after receiving only two payments. As a result, mother has received $600,000 in note payments and removed $2 million of property, plus appreciation, from her estate. If mother is in the 40% marginal estate tax bracket, then the transaction has reduced the estate by $560,000 ($2 million minus $600,000 in installment payments x 40% federal estate tax rate), not taking account of appreciation.

2. Another possible advantage to a SCIN is as a retirement planning device. The SCIN can allow younger generation family members to supplement a parent's retirement income without gift tax. Because of the premium required on a SCIN, the payments in a SCIN would generally exceed payments under conventional installment sales or private annuities. This can provide a larger amount of income for older family members in their retirement years.

3. To avoid a gift, the self-canceling feature should provide a premium to the seller. <u>See</u> <u>Moss v. Comm'r</u>, 74 TC 1239 (1980).

    a. The premium may be reflected either in the interest rate or in the purchase price and other terms.

    b. Using separate counsel or valuation professionals helps substantiate the premium as a bargained-for element of the transaction.

    c. Several valuation programs provide recommendations on the amount of the premium, based on the term of the note and life expectancy of a person the same age as the seller.

    > **EXAMPLE:** Carlos sells a $5,000,000 asset to an irrevocable trust he created for a 15-year self-cancelling installment note, with amortized payments. Carlos is age 70 at the time of the transfer. Using the NumberCruncher program produced by Leimberg & LeClair, Inc., if the parties choose to reflect the premium in the interest rate, the note should pay interest at a rate of 4.837% rather than 2.64%. If the parties choose to reflect

the premium in the purchase price, the principal amount of the note should be $5,838,519 rather than $5,000,000.

4. The IRS challenged the valuation of a SCIN in the recently settled docketed Tax Court case, Estate of Davidson v. Comm'r. The SCIN in that case was an interest-only note with a balloon payment. The IRS asserted that taxpayers could not rely on the actuarial factors embodied in the Section 7520 tables to determine premiums; that the tables apply only to the valuation of life estates, annuities, and remainder interests, not to promissory notes. The application of a pure willing buyer-willing seller analysis for SCINs would significantly complicate their use.

5. The income tax treatment of SCINs is discussed in General Counsel Memorandum 39503 (June 28, 1985) and Frane v. Comm'r, 98 TC 341 (1992) rev'd in part 998 F2d 567 (8th Cir 1993). SCINs offer a number of advantages that may make them preferable to private annuities under appropriate circumstances.

    a. If the transferred property is used in a trade or business or held for investment, a SCIN generates deductible interest for the buyer. For buyers in high income tax brackets, the SCIN's risk premium may generate larger interest deductions if the premium is paid in the form of higher interest. Alternatively, the premium can increase the buyer's basis and depreciation deductions if it is paid in the form of a higher purchase price.

    b. Whereas a SCIN limits the number of payments to the seller, payments under a life annuity may continue long enough to defeat the estate reduction purpose of the original transfer.

6. If the holder of the SCIN dies before receiving all of the note payments, nothing is includible in the gross estate, but the Internal Revenue Code Section 453B installment obligation disposition rules apply and accelerate the balance of the gain by treating the cancellation as a transfer. The transfer is deemed to be made by the decedent's estate, and is taxable to the estate under Internal Revenue Code Section 691(a)(2), with the income being includible on the decedent's estate's first fiduciary income tax return (Rev Rul 86-72, 1986-1 CB 253, and Frane). It is not clear how this treatment would apply in the case of a sale to a grantor trust.

7. For a SCIN transaction to be effective, the sale must be a bona fide transaction. In Costanza v. Comm'r, TC Memo 2001-128 (June 4, 2001), the Tax Court found that SCIN failed since the sale was from a father to a son, the son failed to make interest payments in a timely fashion (and only three payments were made before the father's death), and given the father's history of illness, there was a high probability that father would not survive the eleven year term of the note. The Tax Court's decision

was subsequently reversed (320 F3d 595 (6th Cir 2003) but even on appeal, the court noted that the starting point in analyzing such inter-family transactions should be that there is not truly arm's length dealings between the parties.

R. Comparison of GRAT and IDGT

1. The GRAT and the sale to an IDGT are often alternatives to be considered for the same asset. Both are especially effective if the asset involved is stock in an S corporation or interests in another type of flow through entity, like a partnership or LLC.

2. Advantages of a sale to an IDGT.

a. A sale to an IDGT generally allows the client to use a lower discount rate.

(1) The interest rate required for the promissory note in a sale may be lower than the rate used for determining the value of an annuity interest in a GRAT. If the promissory note uses the applicable federal rate (AFR), the rate should be adequate to avoid gift tax consequences. In a GRAT, the value of the annuity is calculated pursuant to Section 7520 using 120% of the mid-term AFR. A lower rate for the promissory note results in less property being paid back to the grantor.

(2) For many years, the long-term AFR was below the Section 7520 rate. For example, in May, 2007, the Section 7520 rate was 5.6%. The long-term AFR was 4.90%.

(3) More recently, this has not been the case. The February 2016 Section 7520 rate of 2.2% is less than the long-term AFR of 2.62%. It is greater than the mid-term AFR of 1.82%.

b. A sale to an IDGT does not involve a direct mortality risk.

(1) If the client engages in a sale and dies before the end of the term of the promissory note, only the value of the unpaid balance of the note will be included in his estate. If he dies during the GRAT term, the entire value of the transferred property is included in his estate.

(2) However, as explained in the previous Section, there are other possible tax consequences to dying during the term of an installment note.

(a) If the installment sale is not properly structured as an arm's length transaction, and the grantor dies while the note is outstanding, the IRS could treat the note as a retained interest in the trust, and include part or all of the trust in the grantor's estate under Internal Revenue Code Section 2036.

(b) Upon the grantor's death, the trust will lose its grantor trust status.

c. An individual can engage in generation-skipping tax planning with a sale to a grantor trust by allocating GST exemption to the trust.

(1) If an individual gifts $10,000,000 to a grantor trust, and then sells $100,000,000 worth of stock in exchange for a note from the trust, she would need to allocate $10,000,000 of GST exemption to the trust, an amount sufficient to cover the initial gift.

(2) The GRAT is subject to the ETIP rules. A taxpayer cannot allocate GST exemption to the GRAT until the end of the annuity term, at which time the then-current value of the trust is used for the allocation.

d. There is more flexibility in structuring the payments to the grantor in an installment sale. For example, a balloon principal payment can be used, the interest rate can be tied to the prime rate, or the term of the note and interest can be renegotiated after the sale is completed. A GRAT must pay the annuity every year and the annuity may change only as provided in the regulations. See Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

e. The installment sale can provide for prepayments of principal. That alternative is not available in a GRAT.

3. Advantages of a GRAT.

a. It often will be possible to have a smaller gift with a GRAT than with a sale to an IDGT of comparable size. The conventional wisdom is that an installment sale transaction will run less of a risk of being challenged for lack of substance if the trust that is the purchaser has assets equal to at least 10% of assets being sold to it. If there is not a pre-existing grantor trust, this can mean that a considerable gift is necessary to fund the trust.

(1) For example, assume an individual wishes to sell $25 million of stock to a grantor trust for a 20-year note. The individual would need to fund the trust with an initial gift

of $2.5 million. Even if both the individual and his or her spouse had their full lifetime exclusions of $2,000,000 remaining, there would be gift tax due on the gift.

(2) For a GRAT, the gift is tied to the size of the annuity and the length of the annuity term. Thus, if an individual wishes to transfer a significant asset that is expected to have a very high rate of appreciation, the gift may be more affordable if a GRAT is used.

(3) For example, assume the same individual transfers $27.5 million to a Walton GRAT paying 8.5% per year for a term of 20 years. If the individual is age 50 and the Section 7520 rate is 6.0%, the gift upon creating the GRAT is $689,110. This is just less than thirty percent of the size of the gift to fund an IDGT for a sale with the same total amount of stock.

b. A GRAT also provides more protection if the IRS challenges the value of the asset being transferred.

(1) With an IDGT, if the individual sells a $5,000,000 asset for a $5,000,000 note, and the value of the asset is increased on audit to $6,000,000, then, absent a value adjustment clause or Wandry type provision, the individual would be treated as making a $1,000,000 gift.

(2) In a GRAT, the annuity is usually expressed as a percentage of the initial fair market value of the assets contributed to the trust. If the IRS increases the value of the assets transferred to a GRAT on audit, the annuity also increases. The gift does not increase dollar-for-dollar with the increase in the value of the assets. As illustrated in the second example, if the GRAT is effectively a zeroed-out GRAT, the impact of adjusting the value of the property initially transferred to the trust is virtually nil.

> **EXAMPLE:** Jane, age 55, transfers a $5,000,000 asset to a GRAT and retains the right to receive a 12.5% annuity for 10 years. Jane is treated as making a gift of $311,500. On audit, the IRS proposes to increase the value of the asset to $6,000,000. The annuity that the GRAT must pay each year would increase from $625,000 to $750,000. The gift would increase to only $373,800.

EXAMPLE: Jane transfers a $5,000,000 asset to a GRAT and retains the right to receive a 23.4818% annuity for 5 years. Jane is treated as making a gift of $20.33. If the IRS proposes to increase the value of the asset to $6,000,000, the gift would increase to $24.39.

c. The size of the gift also is relevant in considering the possibility that the asset transferred could drop in value, or grow only modestly. If this occurs, it is possible that all the assets in the GRAT or IDGT will be paid back to the grantor to satisfy the annuity or note payments. If the grantor has made a larger taxable gift to fund the IDGT, those assets all could end up being paid back to the grantor, with no restoration of applicable exclusion amount used to make the initial gift, or no credit for any gift tax paid.

d. Finally, because the GRAT is a statutorily sanctioned technique, there is more certainty about how it will be treated by the IRS. Assuming the value of the asset transferred to the GRAT is not questioned, the grantor knows how the transaction will be treated for transfer tax purposes. The determination of the values of the annuity interest and the gift are mechanical calculations using the IRS valuation tables.

(1) There are more uncertainties with a sale to an IDGT. As previously explained, if the grantor trust is not adequately funded or if the sale is not otherwise structured as an arm's length transaction, the IRS could challenge the substance of the transaction and treat it as something other than a sale.

(2) The one aspect of an IDGT that does not have to be strictly arm's length is the interest rate. As previously described, if the note bears interest at a rate equal at least to the AFR applicable for the term of the note, the interest should be adequate, even if the AFR is below the commercial interest rate for such a transaction. The IRS seems to have conceded that an interest rate at least equal to the AFR is sufficient.

S. Special Planning with Grantor Trust Status

1. Supercharged Credit Shelter Trust[5]

   a. The goal behind a supercharged credit shelter trust is to increase the effectiveness of a credit shelter trust for transfer tax purposes by making it a grantor trust as to the surviving spouse.

   b. This allows the trust to continue to have the same benefits that a grantor trust does during the life of the grantor.

   c. The supercharged credit shelter trust starts as a lifetime QTIP trust created by one spouse in a couple for the other spouse.

      (1) During the life of the beneficiary spouse, the trust operates as a marital trust, paying all the income to that spouse.

      (2) The trust is treated as a grantor trust for income tax purposes because the spouse is a beneficiary. IRC § 677.

   d. On the death of the beneficiary, the trust is included in that spouse's estate and the trust property (or that portion equal to the deceased spouse's remaining applicable exclusion amount) can pass to a credit shelter trust for the grantor spouse. The trust continues as a grantor trust for that grantor spouse. See Treas. Reg. § 1.671-2(e)(5).

   e. The goal of course is to have the spouse most likely to survive create the lifetime QTIP trust. Each spouse could create a lifetime trust for the other, and vary the terms sufficiently to avoid possible application of the reciprocal trust principles. In that case, only one trust ultimately will be supercharged.

2. Beneficiary Irrevocable Grantor Trust ("BING")

   a. The Beneficiary Irrevocable Grantor Trust is designed to take advantage of the provisions of Section 678 of the Internal Revenue Code which make the beneficiary of a trust the grantor for income tax purposes under certain circumstances.

   b. Internal Revenue Code Section 678(a) provides that a person other than the grantor will be treated as the owner of any portion of a trust with respect to which that person has a power of withdrawal or previously had such a power and partially released or modified it, assuming the person continues to have interests in the trust that

[5] The "Supercharged Credit Shelter Trust" is a service mark of Jonathan G. Blattmachr, Mitchell M. Gans, and Diana S. C. Zeydel. They first advanced the concept in various articles and presentations.

would cause an actual grantor to be treated as the grantor under Internal Revenue Code Sections 671 through 677.

c. The IRS has repeatedly applied Internal Revenue Code Section 678 to the Crummey trusts, and maintained the position that the beneficiary becomes the grantor of the trust for income tax purposes to the extent of the portion of the trust attributable to lapsed Crummey powers.

d. A wealthy taxpayer can take advantage of these rules by having a parent or other family member create a Crummey trust for the taxpayer. The trust can be funded over a few years with $5,000 gifts, subject to a Crummey power in the wealthy beneficiary. The Crummey power lapses, and the beneficiary treats the trust as taxable to him or her.

> **EXAMPLE:** John is an entrepreneur with a significant estate. John's mother creates a trust for John and his descendants in November and funds it with $5,000 gifts in November and January of the following year. The gifts are subject to a Crummey right of withdrawal in John. The trust is treated as subject to Internal Revenue Code Section 678, and the income is reportable by John on his Form 1040.

e. John now can sell property to the trust in an installment sale, with the tax attributes being identical to any sale to a IDGT. However, John also maintains a beneficial interest in trust. Furthermore, the trust continues as a grantor trust as to him for his life, long after his mother is deceased.

> **EXAMPLE:** In June of year two of the trust, John sells $5,000,000 of stock in a venture capital entity to the trust in exchange for a $5,000,000 note. The sale is treated as a sale to a grantor trust. The entity liquidates 5 years later and pays out $10,000,000 to the trust. The trust repays the note.

f. The transaction is possibly subject to IRS attack because the trust is under-capitalized at the time of the sale. Guarantees would need to be provided to address this risk.

g. In addition, there is much greater risk to the transaction if the IRS is successful in arguing that the property transferred has a greater value. If John is treated as making a gift to the trust, Internal Revenue Code Section 2036 will apply because he also is a beneficiary.

3. Delaware Irrevocable Non-grantor Trust ("DING")

a. The IRS has been asked to rule repeatedly on the income and gift tax consequences of a trust intended to be an incomplete gift, non-grantor trust. A trust of this nature is commonly referred to as a Delaware incomplete gift non-grantor trust or "DING," if created under Delaware law, or a Nevada incomplete gift non-grantor trust or "NING," if created under Nevada law.)

b. As its name implies, a DING or a NING is structured to be a non-grantor trust for income tax purposes that is funded by transfers from the grantor that are incomplete gifts for gift tax purposes. Assuming the trust is established in a state that doesn't tax the income accumulated in the trust (like Delaware or Nevada), the trust will avoid state income taxes as long as the state of residence of the grantor or beneficiaries doesn't subject the trust's income (or accumulated income) to tax. Moreover, if structured and administered properly, the trust property should be protected from the grantor's creditors.

c. The DING or the NING allows a grantor to achieve both of these benefits while still being able to receive discretionary distributions of trust property and without paying gift tax (or using any gift tax exemption) on the transfer of property to the trust. A gift from the grantor will be complete upon a subsequent distribution from the trust to a beneficiary other than the grantor, and whatever property remains in the trust will be subject to estate tax at the grantor's death.

d. A DING or NING is particularly attractive for a highly appreciated asset in anticipation of sale of that asset. For example, the founder of a business that is going to be sold may face hundreds of thousands or even hundreds of millions of dollars of capital gain because he or she has so little basis. Avoiding state income tax on those gains can be a significant benefit.

e. The IRS does not appear to be closely scrutinizing these trusts. They are issuing frequent rulings approving them. <u>See</u>, <u>e.g.</u> Letter Rulings 201440008 through 201440012 (Oct. 3, 2014); Letter Rulings 201436008 through 201436032 (Sept. 5, 2014); Letter Rulings 201430003 through 201430007 (July 26, 2014); Letter Rulings 201410001 through 201410010 (March 7, 2014).

(1) The Service may view these trusts as beneficial to the bottom line. A non-grantor trust may pay slightly more tax than an individual taxpayer.

(2) States are that the ones that lose tax dollars from these trusts. New York passed legislation, effective for income earned on or after January 1, 2014 (unless the trust was liquidated before June 1, 2014) to treat such trusts as grantor trusts for New York income tax purposes.

f. The key in creating an effective DING or NING is to structure distribution provisions that leave the grantor with enough control so that the initial transfer to the trust is not a completed gift, but there is sufficient involvement of parties adverse to the grantor to avoid the grantor trust rules. For example, the trust would permit distributions to the grantor or the other designated beneficiaries as follows:

(1) The trustee must distribute to the grantor or a beneficiary at the direction of a majority of a distribution committee, with the grantor's written consent;

(2) The trustee must distribute to the grantor or a beneficiary at the unanimous direction of the distribution committee;

(3) The grantor, in a non-fiduciary capacity, may distribute to any beneficiary for health, maintenance, support or education.

(4) The initial distribution committee was the grantor, her children and her stepchildren. The committee always must have at least two members other than the grantor.

T. <u>Low-Interest or Interest-Free Loans</u>

1. A simple way for a client to take advantage of the current low interest rate environment is to lend funds at the AFR to a child, grandchild or trust for the benefit of one or more descendants, to enable the recipient to take advantage of investment opportunities with a potential for high returns.

> **EXAMPLE:** Clara creates an irrevocable grantor trust in June, 2006 for the benefit of her descendants. Clara makes a $1,000,000 taxable gift to the trust in 2015, which she splits with her spouse, and which uses a portion of their applicable exclusion amounts. They allocate GST exemption to completely exempt the trust. Thus, after the gift, they have a $1,000,000 trust that is completely exempt from gift, estate and GST taxes. In January 2018, Clara lends an additional $2,000,000 to the trust for a 5-year note bearing interest at 1.67% annually (the mid-term AFR). The principal is due in a balloon payment at the end of the term.

2. Several benefits may result from this arrangement.

   a. The trust has obtained $2,000,000 of investment capital at a rate less than what is available commercially.

   b. The annual interest cost for the loan is $33,400 (1.67% of $2,000,000), or $167,000 in total over three years.

   c. If the trust invests the $2,000,000 and earns a return of 7% annually over 5 years, it will earn over $105,000 per year on the spread. (This is in addition to earnings on the original $1,000,000 corpus received by gift.)

   d. After the repayment of principal after 5 years, the trust will have $613,025 remaining from the loaned funds, plus the $1,000,000 originally given to the trust plus investment earnings on that $1,000,000.

3. If the trust is structured as a grantor trust, the grantor will be responsible for all income taxes on income generated by the trust. In addition, the annual interest payments on the loan will not be taxable income to the grantor. In the foregoing example, the annual $33,400 of interest payments to Clara will not be taxable income to Clara.

4. There is no additional gift or generation-skipping transfer to the trust as a result of the loan.

5. In the proper circumstances, the client may want to consider an interest-free loan instead of a low-interest loan.

   a. If the loan is made to a grantor trust, the grantor should not have to recognize imputed interest income, because the loan is not being made to a separate taxpayer.

   b. There will be an imputed transfer that is treated as a gift. In a term loan that charges no interest, the amount of the gift will equal the difference between the amount lent and the present value of all principal payments due under the loan, discounted using the relevant AFR on the date of the loan. The gift is deemed to occur on the date of the loan.

      EXAMPLE: Chris makes an interest-free loan of $295,000 to an irrevocable grantor trust that he previously created and funded with $300,000. The term of the loan is 10 years, with the principal due in a single balloon payment at the end of the term. If the AFR at the time of the loan is 5.3%, the present value of the loan is about $175,000, and

Chris is treated as making a gift of $120,000 ($295,000-$175,000).

c. If the trust contains Crummey powers, it may be possible to grant the beneficiaries withdrawal rights at the time the loan is made and thereby qualify the imputed gift for the annual exclusion. Recognize that this particular treatment has not been reviewed or ruled upon by the IRS. However, if the Crummey powers are otherwise properly structured and documented, and there are trust assets available to satisfy the withdrawal rights if they were exercised, the present interests created in the trust beneficiaries should be treated as having substance.

d. In this context, the interest-free loan becomes an alternative to a direct annual exclusion gift to the trust.

> **EXAMPLE:** Chris makes a $295,000 interest-free loan to an irrevocable grantor trust under the same facts as the previous example. The trust grants each of Chris's descendants a Crummey power of withdrawal. At the time of the loan, notice of withdrawal rights are given to Chris's three children and three grandchildren, and the $120,000 imputed gift is treated as six annual exclusion gifts. The trust invests the $295,000 in investments that return 8%. After 10 years, the trust has $636,883 as a result of investing the borrowed funds. After repaying the $295,000 loan, the trust has $341,883 from the loan.

If Chris had made a $120,000 direct gift to the trust, and the trust invested the funds for 10 years at 8%, it would have $259,071 after 10 years. The interest-free loan provides $82,812 more for the trust.

e. An individual also could make an interest-free demand loan to a grantor trust. With a demand loan, the imputed interest each year is treated as a gift in that year.

> **EXAMPLE:** Chris makes a $7,000,000 interest-free loan to an irrevocable grantor trust. The AFR at the time is 1.67%. Chris is treated as making a gift of the imputed interest on the loan for the year, which is $116,900. The trust grants Crummey powers to Chris' six descendants, and he treats the gift as qualifying for the annual exclusion.

f. The danger with demand loans is that the lender cannot lock in an interest rate. If the AFR goes up, there will be more imputed interest and a larger gift.

U. FLPs and LLCs

1. Over the past 25 years, many individuals have been using a family-owned limited partnership ("FLP") or limited liability company ("LLC") as a vehicle for managing and controlling family assets.

   a. A typical family partnership is a limited partnership with one or more general partners and limited partners.

   b. Usually, the parents act as general partners of the partnership or own a controlling interest in a corporate general partner. As general partners, the parents manage the partnership and make all investment and business decisions relating to the partnership assets. The general partnership interest usually is given nominal value, with the bulk of the partnership equity being limited partnership interests.

   c. Initially, the parents receive both general partnership interests and limited partnership interests. Thereafter, the parents can transfer their limited partnership interests to the children.

      EXAMPLE: Parent transfers $10,000 of his $1,000,000 of real estate, cash and securities to his children. Parent contributes the remaining $990,000 of investments to a newly formed partnership, to which the children contribute their $10,000. Parent receives a general partnership (GP) interest worth $10,000 and limited partnership (LP) interests with a net asset value of $980,000. The children receive $10,000 of LP interests. Parent make gifts of the $980,000 of LP interests to children.

2. An LLC can be structured in much the same way as a limited partnership. The parents or one of them, often act as Manager and thereby control the decision-making. Initially, the parents receive the bulk of the LLC member interests. Over time, they can transfer most or all of those interests to their children. The LLC can provide an attractive alternative to the use of a partnership, especially where there is a desire to limit the personal liability of all the participants in the entity without having to create a separate entity for the general partner.

3. Non-Tax Estate Planning Benefits

a. The FLP or LLC addresses the problems faced by many individuals who may be in a financial position that would permit them to gift property to children, but who are reluctant to do so because they are unwilling to give up management and control of the property, or do not want children to own the property directly.

b. The FLP or LLC interests represent a right to a share in the entity income and capital, but grant no voice in management of the entity. This structure permits an individual to make gifts of FLP or LLC interests to his spouse, children, and (eventually) more remote descendants, without transferring the underlying assets. As general partner of the partnership or manager of the LLC, the individual can continue to exercise control over the transferred interests. Thus, the individual can transfer interests in the entity to reduce the value of his estate, and retain authority to manage the property. This combination is difficult to achieve in most circumstances. Normally, if a person gives away property, he can no longer exercise control over it.

c. The partnership or LLC agreement also can restrict the ability of any recipient of interests to make further transfers of those interests, by limiting the persons to whom any transfer could be made during life or at death, and the amount that the entity would be willing to pay a partner upon liquidation of his or her interest. These restrictions will help ensure that the interests are kept in the family and will help protect the underlying assets from potential creditors of a child, or from a spouse of a child in a failed marriage.

d. Many of the benefits that a FLP or LLC provides also can be achieved by making gifts to an irrevocable trust for children or more remote descendants. In a number of respects, though, a FLP or LLC provides flexibility not available in a trust.

(1) Unlike an irrevocable trust, the terms of the FLP or LLC can be amended to address changing circumstances.

(2) A FLP or LLC gives the managing partner or the manager greater latitude with respect to management decisions than a trustee of a trust may have. A managing partner's or manager's actions will be judged under the "business judgment rule" rather than the more restrictive "prudent man rule" applicable to a trustee.

(3) Although an individual who creates an irrevocable trust often can retain management control over trust assets by naming himself as investment adviser, the individual

generally cannot retain the trustee's discretionary authority to make distributions without causing Internal Revenue Code Sections 2036 or 2038 to apply.

(4) The long-standing law with respect to business entities has been that the individual can retain this control as general partner of a FLP or manager of the LLC without Internal Revenue Code Section 2036 or 2038 applying. See United States v. Byrum, 408 U.S. 125 (1972). The IRS has ruled that the general partner's powers do not cause transferred limited partnership interests to be included in his estate under Section 2036 or 2038 because the partner's authority is considered to be limited by his fiduciary obligations to other partners. Letter Rulings 9415007 (August 26, 1994); 9332006 (August 20, 1993); 9131006 (April 30, 1991). In Estate of Strangi v. Comm'r, TC Memo 2003-145, this principle became subject to question for the first time, and the IRS now is aggressively attacking it.

4. Valuation Discounts

a. FLPs and LLCs also can be used in many cases to obtain additional valuation discounts. It should be possible to discount the value of the limited partnership interests for gift and estate tax purposes below the value of the underlying partnership assets because the interests lack marketability and control.

b. As with interests in a closely held corporation, there is no ready market for closely held limited partnership interests. By their very nature, limited partnership interests do not participate in management of the partnership and therefore lack control. These characteristics of a limited partnership interest make it less valuable than the assets transferred upon formation of the partnership.

c. In effect, one can transfer assets to a partnership in order to create a closely held business and take advantage of discounts where they otherwise would not be available. The benefit of these discounts, of course, is that they enable an individual to give away more property.

EXAMPLE: After creating a partnership with \$1,000,000 of real estate, cash and securities, Parent gifts \$980,000 of LP interests to his children. He discounts those interests by 35% to reflect their lack of marketability and control. This enables Parent to transfer the LP interests for \$637,000, and possibly shelter the entire gift with applicable credit amount and annual exclusions.

5. A FLP or LLC can be particularly beneficial with assets such as real estate (held directly or through other partnerships) and business assets, because it permits ownership to remain consolidated while economic interests in the assets are given away in the form of partnership or LLC interests. The entity also can hold other investment assets, such as marketable securities. (A FLP or LLC cannot hold stock in a Subchapter S corporation because a partnership cannot qualify as a Subchapter S shareholder.)

6. A FLP or LLC also may be used to shift future growth in the value of assets to younger generations, permitting that growth to escape transfer tax, while at the same time permitting an individual to retain the income from those assets. This is done by creating an entity with two basic types of interests, (i) those that have a fixed value but a preferred cash flow ("frozen interests"), and (ii) those that share in all future appreciation ("growth interests"). This technique is called a partnership "freeze." In a FLP structured as a freeze, Parents retain the frozen partnership interests and give the growth interests to their children or grandchildren, either immediately or over time. The goal is to transfer all or substantially all of the growth interests, because as the underlying partnership assets appreciate, that appreciation is allocated only to the growth interests. If descendants hold all of the growth interests, they will benefit from all appreciation of partnership assets, without any transfer tax cost. Parents also would retain small general partnership interests if they wanted to maintain control of the partnership.

V. <u>State Death Taxes</u>. Many states will have a state death tax. In addition, Connecticut has a state gift tax. Planning will have to be done for residents of states with a state death tax and non-residents with property subject to tax in a state with a state death tax.

1. Planning for individuals who reside in one of these states or who have property subject to a state tax is more complicated than planning for individuals who are not subject to separate state death taxes. The states that currently have a separate state death tax (and their thresholds for tax) are:

State	**Type of Tax**	**2018 Estate Tax Filing Threshold**
Connecticut	Stand-Alone Estate	$2,600,000
District of Columbia	Estate	$11,180,000
Hawaii	Stand-Alone Estate	$11,180,000
Illinois	Estate	$4,000,000
Iowa	Inheritance	
Kentucky	Inheritance	

State	Type of Tax	2018 Estate Tax Filing Threshold
Maine	Estate	$11,180,000
Maryland	Estate and Inheritance	$4,000,000
Massachusetts	Estate	$1,000,000
Minnesota	Estate	$2,400,000
Nebraska	County Inheritance	
New Jersey	Inheritance	
New York	Estate	$5,250,000*
Oregon	Estate	$1,000,000
Pennsylvania	Inheritance	
Rhode Island	Estate	$1,537,656
Vermont	Estate	$2,750,000
Washington	Stand-Alone Estate	$2,193,000

* From April 1, 2017 through December 31, 2018, the New York Exemption is $5,250,000. Then, the New York Exemption is scheduled to equal the federal exemption.

2. The effective combined federal and state tax rate for those states that are decoupled from the current federal state death tax varies depending upon whether the state permits the taxpayer to take into account the federal deduction in calculating the state tax. Internal Revenue Code Section 2058 allows a deduction for the state tax in calculating the taxable estate, which generally resulted in an iterative (or algebraic) calculation. In some of those states, however, the state law does not allow a deduction for the state tax in calculating the state tax itself. This avoids the iterative calculation, but it changes the effective state and federal tax rates. The federal estate tax return (Form 706) was redesigned to accommodate the calculation of tax in such a state by providing a separate line 3a on page 1 for calculating a "tentative taxable estate" net of all deductions except state death taxes, a line 3b for separately deducting state death taxes, and a line 3c for the federal taxable estate (old line 3). The "tentative taxable estate" in effect was the taxable estate for calculating the state tax (but not the federal tax) in such a state.

3. As the following table shows, the marginal federal estate tax rate in 2018 is 33.6% or 34.5% depending on whether the state allows a deduction for the state tax itself.

Top Marginal Estate Tax Rates			
	Federal	**State**	**Total**
2018			
"Coupled" State	40%	0	40%
Ordinary "Decoupled" State	34.5%	13.8%	48.3%
"Decoupled" State/No Deduction	33.6%	16%	49.6%

4. The resulting loss of state revenue and state budgetary shortfalls may lead states that lack a state death tax to enact new state death tax legislation. Two states have already done this. In 2009, Delaware, which had lacked a state death tax since 2005, reinstated its state death tax and then sunsetted the estate tax effective January 1, 2018. Hawaii enacted and estate tax in 2010. Vermont lowered the threshold for its state death tax in 2009. However, it should be noted that some states actually phased out or eliminated their state death taxes at different points. These states included Virginia, Wisconsin, Kansas, Indiana and Oklahoma. New Jersey has repealed its state estate tax, but not its inheritance tax as of January 1, 2018. Delaware, as noted above, has sunsetted its estate tax as of January 1, 2018. Other states have increased their thresholds for state death taxes. These states include Maine, Maryland, New York, and Rhode Island. Minnesota in 2017 enacted a phased-in increase in its exemption to $2.1 million in 2017, $2.4 million in 2018, $2.7 million in 2019, and $3 million in 2020 and thereafter. Connecticut was the latest when on October 31, 2017, the Connecticut Governor signed the 2018-2019 budget which increased the budget for the Connecticut state estate and gift tax to $2,600,000 in 2018, to $3,600,000 in 2019, and to the federal estate and gift tax exemption in 2020. Beginning in 2019, the cap on the Connecticut state estate and gift tax is reduced from $20 million to $15 million (which represents the tax due on a Connecticut estate of approximately $129 million).

5. Not all states that have a state death tax, as noted above, set the same threshold for the imposition of the tax or enacted consistent provisions concerning whether it would be possible to make an election to qualify a QTIP trust for a state marital deduction distinct from the federal election. The variation in state laws since the enactment of the 2001 Tax Act resulted in a dramatic increase in estate planning complexity for individuals domiciled or owning real or tangible personal property in states with a state death tax. Individuals have explored numerous techniques for dealing with state death taxes, such as change of domicile, creation of legal entities to hold real property and movables, and use of lifetime gifts.

6. The states with a separate state estate or inheritance tax that specifically permit a QTIP election are Illinois, Kentucky (for separate inheritance tax), Maine, Maryland, Massachusetts, Minnesota, Oregon, Pennsylvania (for separate inheritance tax), and Rhode Island (for separate inheritance tax).

7. As noted above, portability of the federal exclusion provides further planning options. A couple can avoid all estate tax at the first death by passing property to the survivor in a form that qualifies for the marital deduction. The estate of the first spouse to die can elect portability, giving the survivor $22,400,000 of exclusion in 2018.

8. The failure to shelter property from state estate tax at the first death can increase overall state estate taxes. Currently, only Hawaii permits portability at the state level. A common solution is to use a credit shelter trust for the state threshold amount and then elect portability for the unused exclusion of the first spouse to die.

9. In an era of a greater federal estate tax exemption, individuals in states with a state death tax still have plenty of opportunities to implement strategies that minimize the impact of state death taxes, through a combination of lifetime transfers, change in domicile, and deferral of payment of state taxes by use of state QTIP elections. But the planning is more difficult because of the separate rules often affecting state and federal taxation.

10. Individuals in states with a state estate tax may decide to move to state without a state estate tax to avoid a state estate tax. Likewise, if an individual lives in a state with high state income and property taxes, the new limitations on the deduction for state and local taxes may encourage a move to a state without a state income tax or with lower state income taxes and lower property taxes.

Case Studies

Case Study A:

- Anne is a widow whose husband died in 1995
- She and the children are beneficiaries of a credit shelter trust originally funded with $600,000
- Current value of trust assets = $1,000,000
- Anne's other assets are valued at $3,000,000
- Anne is 89 years old

Case Study B:

- Bob and Sandy are 65. They have two children and four grandchildren. They live in Virginia (no state estate tax).
- They have assets of $10 million
- Current estate plan relies on portability
- Variations:
    - Live in state with estate tax
    - Second marriage, they each have two children and four grandchildren
    - Assets of $20 million
    - Age 85

Case Study C:

- Carlos and Maria are in their 40s
- They have three minor children
- They have assets in excess of $100 million, largely from the sale of a business Maria started and sold
- Both Carlos and Maria are currently involved with new start up businesses

Case Study D:

- Diana is a 85 year old widow whose husband Art died 20 years ago
- Prior to Art's death, they formed an FLP and funded it with real property and securities
- Art's interest in the FLP passed to their 3 children and 3 GST trusts at his death
- Diana made gifts of ~$5 million prior to this year

- Diana still owns 27% of the FLP (FMV ~$4 million)
- Diana has assets outside the FLP (FMV ~5 million)

Case Study E:

- Ed owns a successful construction business worth $20 to $40 million, as well as a large home and other assets
- Ed and Jennifer have 5 children, all minors
- Ed supports his mother Frances, who is 75, has very few assets, and is in relatively poor health

Case Study F:

- Fran founded a manufacturing business taxed as an S-corporation and has, over the years given, and sold 70% to children/grandchildren and (PRIMARILY) to a multi-generation, grantor trust
- Fran, now 87 and retired, holds a note from the grantor trust
- Various family members work for the company and all enjoy distributions
- The company would like to make investments and benefit from the 21% income tax rate

Case Study G:

- George, an accomplished professional athlete, provides life-style advice, conducts fitness consulting and sells various fitness / diet products
- Can the advice/consulting services be separated from the fitness/diet products? What about book sales? Or online course subscriptions about health generally?
- How important is George's personal reputation to the company?
- Can George associate with other similar gurus to "diminish" the importance of his personal skills to the enterprise?

PART B

TABLE OF CONTENTS

RECENT DEVELOPMENTS

LEGISLATIVE DEVELOPMENTS

1. IRS Proposes Regulations on Section 199A (August 8, 2018)

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

On August 8, the Internal Revenue Service (IRS) and the Department of the Treasury released proposed regulations on new Section 199A, the 20 percent deduction for qualified business income, added to the Internal Revenue Code of 1986, as amended, by the 2017 Tax Act. Taxpayers and practitioners have eagerly awaited guidance on significant issues that arose with the recent enactment of the new 20 percent deduction. While the proposed regulations answer many questions regarding Section 199A, they leave many significant issues unaddressed.

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

Background

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

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

Operational Rules

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

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

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

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

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

Additionally, the second section of the proposed regulations addresses many issues concerning the UBIA of qualified property, including its allocation among relevant passthrough entities, subsequent improvements to the qualified property, and the effect of certain nonrecognition transactions (for example, like-kind exchanges). The regulations put in place guardrails to prevent taxpayers from gaming the system. For example, the proposed regulations indicate that property is not qualified property if a taxpayer acquires and disposes of the property in a short period unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was not to increase the Section 199A deduction.

Qualified REIT Dividends and Qualified Publicly Traded Partnership Income

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

Aggregation Rules

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

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

> (1) The businesses provide products and services that are the same or typically provided together.
>
> (2) The businesses share facilities or significant centralized elements.
>
> (3) The businesses are operated in coordination with each other.

Under the proposed regulations, an individual taxpayer may aggregate trades or businesses operated through multiple passthrough entities; however, the taxpayer must determine the QBI, W-2 wages, and UBIA of qualified property for each trade or business separately before applying the aggregation rules. The proposed regulations prohibit vertical aggregation of trades or businesses conducted through tiered partnerships.

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

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

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

The proposed regulations also attempt to combat what commentators have called the "crack and pack" strategy. Under this strategy, a business that would otherwise be an SSTB separates all its administrative functions into a separate entity to qualify that separate entity for the Section 199A deduction. To minimize the potential for this abuse, the proposed regulations provide that an

SSTB includes any trade or business with 50 percent or more common ownership that provides 80 percent or more of its services to an SSTB.

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

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

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

The sixth section of the proposed regulations contains special rules for passthrough entities, PTPs, nongrantor trusts, and estates. Passthrough entities, including S corporations and entities taxable as partnerships for federal income tax purposes, cannot claim a deduction under Section 199A. Any passthrough entity conducting a trade or business, along with any PTP conducting a trade or business, must report all relevant information — including QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income — to its owners so they may determine the amount of their respective Section 199A deductions.

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

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

Treasury are requesting comments regarding whether a taxable recipient of an annuity or unitrust interest in a charitable remainder trust (CRT) should be eligible for a Section 199A deduction to the extent the taxpayer receives QBI from the CRT.

Anti-avoidance Guidance for Multiple Nongrantor Trusts

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

2. Notice 2018-54, 2018-24 I.R.B. 750 (May 23, 2018)

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

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

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

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

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

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

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

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

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

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

4. 2017–2018 Priority Guidance Plan (October 20, 2017)

Treasury Department and the Internal Revenue Service release their 2017–18 priority guidance plan

On October 20, 2017, Treasury Department and the Internal Revenue Service released their 2017–18 Priority Guidance Plan which lists those projects which the IRS hopes to complete during the period from July 1, 2017 through June 30, 2018.

Part 1 of the Plan, "Identifying and Reducing Regulatory Burdens," focuses on the eight regulations from 2016 that were identified pursuant to Executive Order 13789 (April 21, 2017) and the intended actions with respect to those regulations. Executive Order 13789 directed the Secretary of the Treasury to identify all significant tax regulations issued on or after January 1, 2016 that (i) imposed an undue financial burden on taxpayers, (ii) added undue complexity to the federal tax laws; or (iii) exceeded the statutory authority of the Internal Revenue Code. An interim report was issued by the Treasury Department on June 22, 2017 which identified eight regulations for review including the proposed regulations on Section 2704 that were published on August 2, 2016. This report was also contained in Notice 2017-38, 2017-30 I.R.B. 147 (July 7, 2017).On October 2, 2017, the Treasury Department in a report entitled "Identifying and Reducing Tax Regulatory Burdens," announced the withdrawal of the proposed Section 2704 regulation.

Item 1 of Part 1 is the withdrawal on October 2, 2017 of the proposed Section 2704 Regulations regarding restrictions on the liquidation of an interest for estate, gift, and generation-skipping purposes.

Part 2 of the Plan, "Near-Term Burden Reduction," lists those items that the IRS believes can be completed in the remaining 8 ½ months of the plan year. The two estate and gift tax related items are "Final regulations under Section 2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption" and finalization of the consistent basis regulations for estate tax purposes under Sections 1014(f) and 6035.

Part 3 of the Plan describes projects related to the implementation of the new statutory partnership audit rules.

Part 4 of the Plan, "General Guidance," describes specific projects by subject area that will be the focus of the balance of the IRS's efforts during the plan year. Part 4 contains the following three items under the heading of "Gifts and Estates and Trusts" for the years 2017 to 2018:

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

2. 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.

3. 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.

The following items were not carried over from the 2016-2017 Priority Guidance Plan:

1. Guidance on qualified contingencies of charitable remainder trusts under Section 664. The IRS did issue Revenue Procedure, 2016-42, 2016-34 I.R. B. 26 on August 9, 2016 which provided a sample provision to permit a charitable remainder annuity trust to qualify even if it did not meet the probability of exhaustion test.

2. Guidance on the definition of income for spousal support trusts under Section 682.

3. Revenue procedure under Section 2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability. Revenue Procedure 2016-49, 2016-49 2016-42 I.R.B. 1 to address this was issued on September 27, 2016.

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

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

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

7. 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 and withdrawn on October 2, 2017 as noted in Part 1 of the Plan.

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

The reduction in the number of items in the 2017-2018 Priority Guidance Plan could be due to one or more factors including (i) a reduction in the IRS's personnel and budget which does not permit the IRS to work on as many items as in the past; (ii) a belief in the leadership of the Treasury Department and other branches of the administration that the estate tax will be repealed as part of tax reform and, thus, work on projects involving the estate tax is unnecessary; (iii) a furtherance of the stated policy of the Trump Administration to reduce the number of regulations; or (iv) simply a recognition by the IRS of its inability to address these issues during the plan year although they may be addressed later.

5. Revenue Procedure 2017-58, 2017-45 I.R.B. 19 (October 19, 2017)

Inflation adjustments for 2018 announced

This Revenue Procedure provides the inflation adjustments for 2018. Some important adjustments in the estate, gift, generation-skipping and fiduciary income tax areas are:

1. The gift tax annual exclusion is increased to $15,000.

2. The estate and gift tax applicable exclusion amount is increased to $5,600,000.

3. For an estate of a decedent dying in 2018, the aggregate decrease in the value of qualified property for which a special use valuation is made under Section 2032A is increased to $1,140,000.

4. The gift tax annual exclusion amount for non-citizen spouses is increased to $152,000.

5. Recipients of gifts from certain foreign individuals must report these gifts if the value of the gifts in 2018 is $16,111.

6. The kiddie tax exemption remains at $1,050.

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

Extension of time to make portability election permitted

Numerous letter rulings (too numerous to list) have been, and continue to be, issued on the same fact pattern. Decedent's estate was less than the applicable exclusion amount in the year of decedent's death. Decedent's estate failed to file a federal estate tax return to make the portability election and discovered its failure to elect portability after the due date for making the election. In each letter ruling, the IRS determined that the requirements of Treas. Reg. § 301.9100-3 for granting an extension of time to make an election were met. Under this regulation, an extension of time will be granted if a taxpayer is deemed to have acted reasonably and in good faith. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer if the tax professional failed to make or advise the taxpayer to make the election. In 2017, the standard fee for a letter ruling requiring an extension of time under Treas. Reg. § 301.9100-3 is $10,000. Revenue Procedure 2018-1, 2018-1 IRB 1.

7. Notice 2017-12, 2017-5 I.R.B 742 (January 6, 2017)

IRS provides guidance on methods available to confirm closing of the estate tax return examination

Prior to June 1, 2015, the IRS issued estate tax closing letters for every estate tax return filed. However, the IRS changed its policies for returns filed on or after June 1, 2015. The IRS will now issue a closing letter for an estate only if the estate requests such a closing letter. The request of an estate for a closing letter is to be made four months after the filing of the estate tax return.

The IRS in this Notice stated that it had previously announced that it would no longer issue estate tax closing letters as a matter of course and noted that different state and local agencies have come to rely upon closing letters for confirmation that the IRS has closed its examination of the estate. In the absence of a closing letter, an account transcript, which is a computer generated report reflecting current account information can be relied upon a substitute for the closing letter. However, the IRS noted that a closing letter is not equal to a closing agreement and that under certain circumstances, the IRS can reopen the examination. A taxpayer can confirm the closing of the IRS's examination of an estate tax return by requesting a transcript of the account. If the account transcript contains a transaction code of "421," this, similar to the receipt of an estate tax closing letter, will confirm the closing of the IRS's examination of the return.

MARITAL DEDUCTION

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

IRS grants extension of time to make QTIP election

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

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

GIFTS

9. <u>Karen S. True v. Commissioner</u>, Tax Court Docket No. 21896-16 and <u>H. A. True III v. Commissioner</u>, Tax Court Docket No. 21897-16 (Petitions filed October 11, 2016)

IRS attacks use of <u>Wandry</u> clause in gift and sale of interests in a family business

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

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

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

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

10. Letter Rulings 201744006 and 201744007 (Issued July 26, 2017; Released November 3, 2017)

Contributions of property to trust by grantors is not a completed gift subject to gift tax

These rulings are some of the latest rulings dealing with incomplete non-grantor trusts that are established in states with state income taxes by residents of those states to avoid state income taxes, usually on the disposition of highly appreciated assets. While these transfers are designed to avoid income taxes, they are not designed to avoid estate taxes when the grantors pass away. These letter rulings dealt with trusts established by residents of a community property state.

In these letter rulings, Husband and Wife created an irrevocable trust for the benefit of themselves, their issue, and each of their fathers. The trust had a corporate trustee as the sole trustee. The grantors, as noted above, resided in a community property state.

Under the terms of the trust, the trustee could distribute income and principal to the beneficiaries and either or both of the grantors as appointed by the Power of Appointment Committee. After the death of the predeceased grantor and until the death of the surviving grantor, the trustee could distribute income and principal to the beneficiaries and the surviving grantor as the Power of Appointment Committee appointed. Any appointment, direction, determination, or action by the Power of Appointment Committee required the unanimous written consent of all members of the Power of Appointment Committee or the written consent of both of the grantors and a majority of the then serving members of the Power of Appointment Committee. The members of the Power of Appointment Committee served and acted in a non-fiduciary capacity. The Power of Appointment Committee consisted initially of the grantors' fathers, and guardians who had the legal authority to act on behalf of the grantors' two minor children.

Each grantor had the power in a non-fiduciary capacity to appoint any principal to any one or more of the issue. The predeceased grantor had a broad special power of appointment over the predeceased grantor's entire interest in the property of the trust. Upon the death of the predeceased grantor, the predeceased grantor's one-half interest in the trust that was not appointed was distributed to members of the committee and the grantor's issue. Upon the death of the surviving grantor, the surviving grantor's interest would be distributed pursuant to a broad special power of appointment, otherwise to the members of the committee and the grantor's issue.

Six rulings were requested:

1. The trust would be treated as a non-grantor trust for income tax purposes.

2. The contribution of property to the trust would not be a completed gift subject to gift tax.

3. Any distribution of property by the Power of Appointment Committee to either grantor would not be a completed gift.

4. Any distribution of property by the Power of Appointment Committee to a beneficiary other than the grantors would not be a completed gift by any members of the committee.

5. No member of the Power of Appointment Committee would be considered to have a taxable general power of appointment which would cause the inclusion of any property held in the trust in his or her estate.

6. The basis of all community property in the trust on the date of the death of the predeceased grantor would be stepped up to the fair market value on the date of death of the predeceased grantor.

With respect to the first request, the Service, as it has in previous rulings dealing with income tax consequences of incomplete non-grantor trusts, ruled that the grantor would not be treated as an owner of the trust under Sections 673, 674, 676, 677, or 679 so long as the trust remained a domestic trust and the Power of Appointment Committee remained in existence. The IRS also concluded that none of the circumstances would cause the administrative controls to be considered exercisable primarily for the benefit of either grantor under Section 675. For that reason, the circumstances attendant on the operations of the trust would determine whether either grantor was treated as the owner of any portion of the trust for Section 675 and therefore that portion would be a grantor trust for income tax purposes. The federal income tax returns of the parties would have to be examined to determine the income tax consequences. None of the members of the Power of Appointment Committee would be treated as an owner of the trust for income tax purposes, because none of the members had a power exercisable by himself or herself to vest trust income or corpus in himself or herself under Section 678(a).

With respect to the second and third ruling requests, the Service concluded that a contribution of property to the trust by the grantors was an incomplete gift. Any distribution from the trust to a beneficiary would be a completed gift at the time of distribution and treated as being made one-half by each grantor. Upon either grantor's death, the fair market value of his or her interest in the property and the trust would be included in the grantor's estate for estate tax purposes. Any distribution from the trust by the grantor was merely a return of each grantor's property and was not a gift. Upon the death of the predeceased spouse, the fair market value of the predeceased spouse's interest in the trust would be included in the predeceased spouse's estate. Upon the death of the surviving grantor, the fair market value of the balance of the trust would be included in the surviving grantor's gross estate for federal estate tax purposes.

With respect to fourth and fifth ruling requests, the Service concluded that any distribution of property by the Power of Appointment Committee to any beneficiary of the trust other than the grantors was not a completed gift by any member of the committee. In addition, the powers held by the committee members were not taxable general powers of appointment.

With respect to the sixth ruling request, the Service concluded that the basis of all community property in the trust on the date of death of the predeceased grantor would be stepped up to the fair market value of the property on the date of death of the predeceased grantor. This was based on Section 1014(b)(6), which provides that the surviving spouse's one-half share of community property is considered for purposes of the step-up in basis rules to have been acquired from or to have passed from the deceased spouse if at least one-half of the whole of the community interest in such property is included in determining the value of the deceased spouse's gross estate.

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

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

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

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

1. An income interest for 21 years after Daughter's death;
2. The remainder interest which vested in possession 21 years after Daughter's death; and
3. A pre-1942 general power of appointment.

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

Several years later, Daughter proposed to partially release her general power of appointment to restrict the power in two respects. First, the power was to be exercisable only in favor of the

Daughter's estate. Second, the power could only be appointed to take effect after her death. The intention of Daughter was to allow her power of appointment over the trust to lapse at her death.

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

The taxpayer requested the following rulings:

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

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

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

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

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

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

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

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

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

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

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

Prior to the enactment of Chapter 14 in 1990, husband, wife, and their six children purchased real estate from an unrelated party for the property's fair market value. Husband, wife, and each of the children executed an agreement whereby husband, wife, and each of the children paid the actuarial value of their respective interests from their own resources and none of the six children used any funds acquired from their parents to acquire their respective interests. Under the agreement, wife acquired a life interest in the use of and income from the real property, husband acquired a life interest in the use of and income from the real property that became effective upon the death of the wife, and each of the children had a $1/6^{th}$ undivided interest in the remainder.

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

The taxpayers requested rulings that:

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

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

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

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

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

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

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

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

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

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

ESTATE INCLUSION

14. Estate of Sommers v. Commissioner, 149 T.C. No. 8 (2017)

Tax Court denies estate tax deduction for gift tax owed at death by decedent on gifts to decedent's nieces

In an earlier case, Estate of Sommers v. Commissioner, T.C. Memo 2013-8, the Tax Court held that a decedent, who then lived in Indiana, made valid gifts of interests in a limited liability company holding artwork to his three nieces in December 2001 and January 2002. Decedent subsequently moved to New Jersey and died in November 2002. Decedent's wife succeeded to the property she owned jointly with decedent and decedent's will gave all of his estate remaining after the payment of debts and expenses to his wife. The wife subsequently died and her beneficiaries became the ultimate beneficiaries of the estate's assets. In accordance with the agreements governing their gifts from decedent, the three nieces paid the gift tax due on those gifts. The estate filed three motions for partial summary judgement seeking determinations that:

1. The gift tax owed at decedent's death on his gifts to nieces was deductible under Section 2053;
2. The estate was entitled to a Section 2056 marital deduction equal to the value of decedent's non probate property that the wife received or to which she succeeded that, under applicable New Jersey law, was exempt from decedent's debts and the expenses of the estate; and
3. Any federal estate tax due must be apportioned to the nieces and thus did not reduce the estate's marital deduction.

The three nieces filed their own motion for partial summary judgment that none of the estate tax liability could be apportioned to them.

In 2001, decedent, who was then divorced from his wife, sought legal advice on how to transfer works from his art collection to the three nieces who were then his closest living relatives. His attorneys offered two proposals to reduce or eliminate gift tax on the gift of the artwork. First the attorneys recommended that decedent transfer the artwork to a newly formed limited liability company and then make gifts of the units representing ownership interests in the entity to the nieces. This recommendation assumed that, as a result of applicable valuation discounts, the appraised value of the units in the limited liability company would be less than the value of the artwork they represented. The attorneys also recommended that the decedent make the intended gifts in two stages, transferring some units to each niece on or before December 31, 2001 and the rest thereafter. Spreading the gifts across two years would increase the portions of the gifts that could be covered by the gift tax annual exclusion. It would also allow the decedent to use the increased applicable exclusion amount of $1 million that was scheduled to take effect in 2002. Decedent wanted to transfer the maximum number of units possible to the nieces without incurring gift tax in 2001 and then complete the gifts of the units in 2002.

In accordance with the plan, decedent transferred the artwork to the LLC and executed two sets of gift and acceptance agreements with his nieces. The first agreement was dated December 27, 2001 and the second was dated January 4, 2002. When decedent and his nieces initially executed the agreements, blanks were left for the number of units for each transfer pending completion of an appraisal of the artwork. The appraisal, when completed in March 2002, assigned a value to the artwork that led decedent's attorneys to conclude that dividing the transfers of the units across the end of 2001 would not allow for the complete avoidance of gift tax. The nieces then agreed to pay any gift tax resulting from the 2002 transfers and the gift and acceptance agreements were completed by filling in the blanks for the numbered units covered by each transfer.

In addition, decedent's nieces amended each of the 2002 agreements to add a provision pursuant to which each niece "agreed to pay the gift taxes, if any, relating to the gift of the units, including without limitation, any gift taxes, penalties, and interest that may later correctly be assessed." None of the 2002 agreements referred to apportionment of any federal estate tax liability resulting from the gifts. While none of the agreements provided for the assumption by the nieces of any liability other than gift tax, none of the agreements specifically exculpated the nieces from other liabilities.

In April 2002, decedent executed his will that directed his executor (his then ex-wife) to pay all of his just debts including funeral and burial costs and expenses of his last illness and all costs and expenses of administering and settling his estate. The nieces received all of decedent's estate remaining after payment of those debts.

In June 2002 shortly before remarrying his ex-wife, decedent initiated litigation in Indiana against his nieces challenging the validity of the purported gifts and seeking return of the artwork. The litigation in Indiana and similar litigation his ex-wife initiated in New Jersey after decedent's death on November 1, 2002 ultimately upheld the validity of the gifts. On the federal estate tax return, decedent's estate took a marital deduction of $3,330,510.43 and after taking account of all deductions, the taxable estate was $507.34. On examination, the IRS increased taxable estate from $507.34 to $1,092,106.68. This increase of $1,091,599.34 reflected three adjustments that followed from the IRS's determination that decedent's transfers of units were valid gifts. First, the IRS included the gift tax determined to be due as a result of the 2002 gifts. This amount of $510,648 was included because decedent made the gifts less than three years before his death. Second, the IRS excluded from decedent's gross estate the $1,750,000 value that the estate had assigned to the artwork that decedent had transferred to LLC. Third, the IRS reduced the marital deduction by $2,330,951.34. The decrease in the marital deduction reflected the IRS's determination that the estate tax liability of $542,593.34 resulting from the inclusion of the gift tax paid within three years of death under Section 2035(b) that would have to be paid out of marital assets.

With respect to the first issue, the court noted that long standing precedent established that a claim against an estate is deductible in computing the estate tax liability only to the extent that it exceeds any right to reimbursement to which its payment would give rise. The court noted that the key question to examine when there was a net gift as here in which the nieces had paid the gift tax owed, is whether a decedent's estate served as the ultimate source of the funds used to pay the liability that arose when the decedent parted with the value. In this case, decedent effectively provided the nieces with the wherewithal to pay tax on the taxable gifts because for each niece, a portion of the units transferred in 2002 was ultimately determined to a taxable gift.

Decedent made the transfers to the nieces before he died, withdrawing from his potential estate not only the value of the taxable gifts but also the amount of the tax on the gifts. The court also noted that if decedent's estate paid the gift tax liability after decedent's death, it would have had a claim for reimbursement against the nieces to whom decedent had already provided the wherewithal for paying the tax. The court stated that inclusion of the gift tax in decedent's estate did not justify allowing deductions for gift tax in this case anymore than in a case of a gross gift for which the decedent paid the gift tax before the decedent died. As the court put it, "[o]ur acknowledgment that a net gift made within three years of the donor's death effects a removal of funds from the transfer tax base that must be redressed by the gross-up cannot be read as acquiescence in the permanent exemption from transfer tax that would result if the gross-up were offset by a deduction of the same amount under Section 2053(a)(3)."

The court also denied the estate's motion for partial summary judgment regarding the effect of the payment of debts and claims on the marital deduction because the amount of the allowable deduction turned on the factual question of the extent to which assets otherwise exempt from claims against the estate were used to pay estate debts and expenses. Section 2056(a) allows a deduction for the "value of any interest in property which passes or has passed from the decedent to the surviving spouse". Treas. Reg. § 20.2056(b)-(4)(a) provides that value for that purpose means net value. Consequently, when property that would otherwise have been distributed to surviving spouse is used to satisfy debts of the estate, it is not included in the allowable marital deduction. The factual question of the extent to which assets otherwise exempt were used to pay debts and expenses precluded summary judgment since this was an issue of material fact and summary judgment may only be granted when there is no issue of genuine material fact.

The court then found that under the New Jersey's estate tax apportionment statute, no portion of any estate tax could be apportioned to the three nieces. Because the LLC units the three nieces received from their uncle were not included in computing the decedent's federal estate tax liability under the New Jersey apportionment statute, the nieces were not "transferees" against whom any of the estate tax liability could be apportioned for purposes of the New Jersey apportionment statute.

The court next looked at whether the payment of the estate tax would reduce the marital deduction claimed by the estate and held that the existing record did not allow for the determination of the effect of the payment of the estate tax on the allowable marital deduction. To the extent that the executor used the property that otherwise would have been exempt from claims against the estate to pay debts or expenses, the estate may have been a "transferee" subject to the apportionment of estate tax under the New Jersey apportionment rules. If neither the estate nor the nieces were "transferees" subject to the apportionment statute, the federal estate tax liability would be apportioned entirely to the estate. To the extent that any tax apportioned to the estate reduced the residuary distributions ultimately made to the wife's beneficiaries, the tax would be paid out of that marital share of the estate. The court did note that the New Jersey statute requires that total estate tax be apportioned in a manner that reserves for the benefit of decedent's spouse, to the extent possible, the benefit of any marital deduction. That statute provided insufficient grounds to rule that as a matter of law any estate tax due could not affect the allowable marital deduction.

15. Letter Rulings 201737001 and 201737008 (Issued June 14, 2017; Released September 15, 2017)

Reformation of power of appointment to make it a limited power of appointment is recognized

Grantor created an irrevocable trust to benefit spouse and descendants. The irrevocable trust contained a special power of appointment that provided that on the death of the spouse, the trustee is to distribute such amounts of principal and income as the spouse directed to such persons or charities as the spouse appointed by her will. The terms of the power of appointment did not specifically limit the exercise of the power to appoint to persons other than the spouse, the estate of the spouse, and the creditors of either. It was represented that the grantor intended for the power of appointment to be a limited power of appointment and not a taxable general power of appointment.

The grantor filed a petition with the local court to reform the trust to provide that the spouse would have a limited power of appointment and for the retroactive application of the reformation. The IRS ruled that because of the representations that the grantor did not intend for the spouse to have a general power of appointment and the representation of the lawyer who drafted the trust that an error had been made, the power of appointment as reformed by the local court would not constitute a general power of appointment and that the reformation of the trust was not the exercise or release of a general power of appointment that would constitute a gift by the spouse for federal gift tax purposes.

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

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

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

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

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

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

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

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

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

17. Badgley v. United States, _____ F.Supp.3d _____ (ND Cal 2018)

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

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

Patricia died on November 2, 2012 having received her last annuity payment from the GRAT on September 30, 2012.

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

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

Treas. Reg. 20.2036-1(c)(2)(i) requires that transferred GRAT property be included in a decedent's gross estate where the decedent retains an annuity interest and dies before the expiration of the annuity term. The court found that the regulation was valid even though Section 2036 does not equate "income" with a fixed term annuity in Section 2036. The silence did not mean that the interpretation of the Section is arbitrary or capricious. Instead the regulation is a permissible interpretation of Section 2036. The court also rejected the argument that the regulation was arbitrary because it would result in the inclusion of all private annuities in the decedent's gross estate and was overly broad to the extent that the regulations subsequently included GRATs such as Patricia's that "have no ordering rule, do not provide for income payments disguised as annuity payments, and at the time of grantor's death can satisfy the annuity payments entirely out of principal." The second argument failed once the court rejected the attempted distinction between an annuity and a right to income.

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

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

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

VALUATION

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

IRS grants extension of time to make Section 754 election

A general partnership was organized under state law. A and B owned a percentage interest in the partnership as community property. B died. The executor intended to make an election under Section 754 in connection with the death of B to step up the basis of partnership property.

However, the executor failed to file a timely return to make the election. The executor represented that it had acted reasonably and in good faith and that granting the relief would not prejudice the interests of the government.

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

19. Letter Ruling 201743013 (Issued July 26, 2017; Released October 27, 2017)

Grandson's sale of interest in specially valued farm property to Daughter within 10 years of decedent's death will not cause an additional tax under Section 2032A

Upon Decedent's death, farm property passed to Daughter for life, and upon her death the remainder interest was to become the property of Daughter's two children. On Decedent's estate tax return, the executors elected special use valuation under Section 2032A. Grandson now proposed to sell his remainder interest in his one-half of the property to Daughter within the ten-year period after Decedent's death. The issue was whether Section 2032A(c) would apply. This Section provides that if within ten years after the decedent's death and before the death of the qualified heir, the qualified heir disposes of any interest in the qualified use property (other than by a disposition to a member of the qualified heir's family), then an additional estate tax is imposed.

Section 2032A(e)(1) defines "qualified heir" as a member of decedent's family who acquired such property from the decedent. If the qualified heir disposes of any interest in qualified real property to any member of his family, such family member is treated thereafter as a qualified heir.

Section 2032A(e)(2) defines a member of the family as an ancestor of an individual, the spouse of such individual, a lineal descendant of such individual, such individual's spouse, the parent of such individual, or a spouse of any lineal descendent.

The IRS noted that in this situation, both Grandson and Daughter are qualified heirs of Decedent because they are lineal descendants of Decedent. Additionally, Daughter is a member of Grandson's family because Daughter is an ancestor of Grandson. Consequently, Grandson's sale of his remainder interest in the farm property to Daughter within ten years after Decedent's death will not be a disposition to a member of the family upon which an additional tax is imposed.

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

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

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

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

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

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

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

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

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

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

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

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

IRS allows extension to elect alternate valuation date

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

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

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

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

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

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

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

24. Estate of Clara M. Morrissette v. Commissioner, ___ Tax Court Order (June 21, 2018)

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

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

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

Any split-dollar arrangement not described above in which the employee owns the policy will be governed under the loan regime by the Section 7872 below market loan rules. 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.

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

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

Pursuant to Estate of Cahill v. Commissioner, T.C. Memo 2018-84, a restriction on a decedent's termination rights is a restriction for purposes of Section 2703. In Estate of Cahill, the Tax Court denied the estate's motion for partial summary judgment that Section 2703(a) did not apply to split-dollar arrangements with termination restrictions similar to those at issue in Morrissette where the parties to the agreements can mutually agree to terminate the arrangement but neither party could unilaterally terminate the arrangements. Here the decedent's trust and the respective dynasty trusts could mutually agree to terminate the split-dollar arrangement but neither party could unilaterally terminate the agreement.

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

25. <u>Cahill v. Commissioner</u>, T.C. Memo 2018-84; subsequently settled on August 16, 2018

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

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

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

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

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

Each split-dollar agreement also provided that it could be terminated during the insured's life by written agreement between the trustees of the Survivor Trust and the MB Trust. As of the date of Richard's date in 2011, the aggregate cash surrender value of the policies was $9,611,624. The estate's tax return reported the total value of decedent's interest in the split-dollar agreements at $183,700. In the Notice of Deficiency, the IRS adjusted the total value of decedent's rights in the split-dollar arrangements from $183,700 to $9,611,624, the cash surrender value of the policies.

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

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

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

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

Cahill was settled on August 16, 2018. The taxpayer conceded the split-dollar valuation issue so that the value is $9,611,624. The taxpayer will also be liable for the Section 6662 accuracy related penalty at the rate of 20 percent.

CHARITABLE GIFTS

26. <u>RERI Holdings LLC v Commissioner</u>, 149 T.C. No. 1 (July 3, 2017)

Tax Court denies income tax charitable donation for gift of LLC interest

RERI Holdings I, LLC ("RERI") donated an LLC interest that was subject to a prior estate for years through 2020 to the University of Michigan in August 2003. RERI had purchased the LLC interest in March 2002 for $2,950,000. However, on its 2003 partnership return, RERI claimed an income tax charitable contribution deduction of $33,019,000 for the transfer to University of Michigan. The income tax return for RERI contained a Form 8283 Appraisal Summary which disclosed the March 2002 purchase, but left blank the place for "donor's cost or other adjusted basis". Two years after receiving the gift, the University of Michigan sold the LLC interest for $1,940,000 to another LLC indirectly owned by RERI.

The IRS disallowed RERI's deduction entirely on the grounds that the transaction was a sham for income tax purposes or lacked any economic substance. RERI moved for summary judgment in the Tax Court on the grounds that neither the sham transaction doctrine nor the lack of economic substance doctrine applied to the charitable gift. The Tax Court held that both the sham transaction doctrine and the lack of economic substance doctrine applied and denied summary judgment to RERI.

The IRS then moved for partial summary judgment that the actuarial tables under Section 7520 could not be used to value the future interest that RERI contributed to the University of Michigan and that RERI had failed to substantiate the value of its contribution with a qualified appraisal. The court denied summary judgment to the IRS on its motion for partial summary judgment.

The court at trial noted that the omission of basis from the Form 8283 violated the substantiation rules because the cost basis would have alerted the IRS to a potential overvaluation of the charitable gift. As a result, the omission cannot be excused on grounds of substantial compliance. The court then noted and found that the actuarial factors under Section 7520 did not apply. It also found that the fair market value of the property contributed to the University of Michigan on the date of the contribution was $3,462,886 and that the gross valuation misstatement penalty would apply.

27. <u>310 Retail, LLC v. Commissioner</u>, T.C. Memo 2017-164

Deed of easement constitutes contemporaneous written acknowledge for charitable income tax deduction for gift of conservation easement

This case was before the Tax Court on cross motions for partially summary judgement as to whether a contemporaneous written acknowledgement for a charitable gift was provided. The court noted that the Form 8283 filed by 310 Retail, LLC when the gift was made did not meet the requirements of a contemporaneous written acknowledgement because it failed to include any information on whether the Landmark Preservation Council to which conservation easement was deeded had supplied 310 Retail, LLC with any goods or services. The July 2009 letter contained that information but it was not contemporaneous.

310 Retail, LLC had filed an amended Form 990 for the tax year that disclosed the façade easement and stated that no goods or services provided exchanged therefore. However, the court held that the Form 990 did not meet the requirements for contemporaneous written acknowledgment since the regulations as in force did not provide for an alternative method to a contemporaneous written acknowledgment.

However, the court found that a deed of easement may qualify as a contemporaneous written acknowledgement if it contains the required information. The court noted that in <u>Averyt v. Commissioner</u>, T.C. Memo 2012-198, the granting provisions stated the donor conveyed a perpetual conservation easement in consideration with the mutual covenants, its terms, conditions and restrictions set forth and as an absolutely unconditional gifts subject to all manners of record. It also stated that this instrument sets forth the entire agreement of the parties with respect to the easement and supersedes all prior discussions, negotiations, and understanding of the agreements relating to the easement all which are merged herein. That deed qualified as a contemporaneous written acknowledgement. As a result, the merger clause, read in connection with the other statements deed of easement, supplied the affirmation that is required for a contemporaneous written acknowledgement that no goods or services were received in exchange for the contribution. The reasoning in <u>Averyt</u> was followed in <u>RP Golf, LLC</u>, T.C. Memo 2012-282.

The court found that the deed of easement in this case was similar in all materials respects to the deed in <u>RP Golf, LLC</u> and stated that the deed would qualify as contemporaneous written acknowledgement.

28. <u>Big River Development, LP v. Commissioner</u>, T.C. Memo 2017-166

Deed of easement constitutes contemporaneous written acknowledge of charitable gift

This case involves a charitable contribution deduction claimed by Big River Development, LP for a conservation easement. The court had previously held that deed of easement may constitute a contemporaneous written acknowledgment in <u>310 Retail, LLC v. Commissioner</u>, T.C. Memo 2017-164; <u>RP Golf, LLC v. Commissioner</u>, T.C. Memo 2012-282; and <u>Averyt v. Commissioner</u>, T.C. Memo 2012-198.

In this case, Big River acquired a property in Pittsburgh, Pennsylvania and began converting the building into a luxury apartment complex. On January 12, 2005, Big River executed a deed of historic preservation conservation easement to the Pittsburgh History and Landmarks Foundation over the façade of the building. The deed of easement noted that Big River was granting to the Pittsburgh History and Landmarks Foundation the façade easement pursuant to Section 170(h) of the code. The deed recited the obligations and would be deemed to run as a binding servitude with the property in perpetuity. It noted that the foundation would monitor Big River's compliance with the easement restrictions. It also noted that Big River was paying the foundation a fee of $93,500 to endow the monitoring of the easement.

Big River secured an appraisal that valued the façade easement at $7.14 million and claimed a $7.14 million charitable contribution deduction on its income tax return. While Big River attached a Form 8283 executed by the appraiser and by the foundation's president, this document contained no statement as to whether the foundation had provided any goods or services to Big River in exchange for its gift. Two years after the gift was made, the foundation supplied Big River with a letter stating that the foundation had not provided any goods or services in exchange for the contribution.

In 2009, the IRS proposed to disallow the charitable contribution deduction because there was no contemporaneous written acknowledgement. In this summary judgment proceeding, the court noted that the requirement of a contemporaneous written acknowledge is a strict one when there is a gift of $250 or more. The Form 8283, while contemporaneous, did not include the statement as to whether the Foundation had provided any goods or services in exchange for the gift. The letter provided by the foundation in 2007 included that statement that it was not contemporaneous. The court however then found that Big River received a contemporaneous written acknowledgement in the form of the deed of easement. It noted that the deed of easement was property executed by the foundation's president contemporaneously with the gift. To the extent that the foundation's monitoring activities constituted the rendering of services to Big River, the deed of easement provided a description and a good faith estimate of the value of those services. Finally, because the deed of easement explicitly stated that it represented the parties' entire agreement, it negated the receipt by Big River of any other goods or services from the foundation. As a result, the deed of easement constituted a contemporaneous written acknowledgement meeting the requirements of Section 170(f)(8)(B).

29. Ohde v Commissioner, T.C. Memo, 2017-137

Husband and Wife denied income tax charitable contribution deduction for over 20,000 items donated to Goodwill Industries in 2011

Mark and Rose Ohde claimed an income tax charitable deduction of $145,250 for over 20,000 items donated to Goodwill Industries in 2011. This included 3,454 items of clothing, 115 chairs, 36 lamps, 22 bookshelves, 20 desks, 20 chest of drawers, 16 bed frames, 14 filing cabinets, and 3,153 books. For each delivery, Goodwill gave them a one-page, generic receipt stating no quantities or values.

For 2007 through 2010, the Ohdes had claimed income tax charitable deductions for non-cash charitable contributions aggregating $292,143. For 2012 and 2013, the Ohdes claimed income tax charitable deductions for non-cash charitable contributions aggregating $104,970. The Tax Court found none of the taxpayers' testimony creditable, disallowed the entire deduction, and sustained an accuracy-related penalty.

Ron Aucutt has offered the following reflection on the Ohde case:

Mark and Rose Ohde
Drove down the road,
And with a load
Goodwill bestowed.

But what they sowed
Would soon implode,
And, per the Code,
Big bucks they owed.

30. Roth v. Commissioner, T.C. Memo 2017-248

Couple liable for penalties for overstating value of easement donation

Husband and Wife donated a conservation easement encumbering 40 acres of land in Prowers County, Colorado. On their 2007 federal income tax return, the petitioners valued the conservation easement at $970,000 and claimed a charitable contribution deduction based on that amount. The petitioners had to carry over part of the deduction to 2008 because of the percentage limitations for the income tax charitable deduction.

The IRS disallowed the deductions and determined income tax deficiencies for 2007 and 2008, respectively. The IRS also determined 20% accuracy related penalties under Section 6662(a) for the two tax years. In its answer to the taxpayer's petition, the IRS affirmatively asserted 40% gross valuation penalties of Section 6662(h) for those tax years. The IRS examiner determined that the conservation easement was improperly valued and that the correct value was zero. The examiner also determined that Husband and Wife were liable for a 40% penalty under Section 6662(h). The examiner determined that in the alternative, Husband and Wife were liable for a 20% accuracy related penalty under Section 6662(a). The parties reached a settlement under which they agreed that Husband and Wife were entitled to a charitable contribution deduction of $30,000 for 2007. The parties also agreed that Husband and Wife had reasonable cause for the value of the charitable contribution. Accordingly, the IRS conceded that Husband and Wife were not liable for the 20% accuracy related penalty under Section 662(a).

The difference in the agreed value of $30,000 and the claimed value of $970,000 also met the test for a gross valuation in statement as defined in Section 6662(h). Unlike the 20% accuracy related penalty, Husband and Wife could not claim reasonable cause to avoid liability for the 40% gross valuation misstatement penalty. However, the petitioners assert that the imposition of the 40% penalty was inappropriate because the IRS failed to comply with procedural requirements to impose the 40% penalty.

In addition, as a result of a claimed donation of an earlier separate conservation easement in 2006, Husband and Wife received Colorado state income tax credits. During 2007, Husband and Wife sold a portion of those credits to another Colorado state taxpayer for $195,000. As a result of litigation in Colorado state court, Husband and Wife repaid $24,662 of that sum in 2013 and a further $83,489 in 2014. Husband and Wife asserted that they were entitled to a deduction for tax year 2007 for the amounts of the repayments in tax years 2013 and 2014.

Husband and Wife alleged the IRS failed to comply with Section 6751(b) which provides that no penalty shall be assessed unless the initial determination of such assessment is personally approved by the immediate supervisor of the individual making such determination or such higher level official as may be designated by the secretary. Husband and Wife asserted that the initial determination referenced by Section 6751(b)(1) is the issuance of the notice of deficiency. While written approval for the gross valuation misstatement penalty was obtained before the issuance of the notice of deficiency, Husband and Wife contended that it was the appeals office that handled their case and not the examiner who made the initial determination with respect to the gross valuation misstatement penalty, and because the appeals officer failed to get approval from his immediate superior, the IRS failed to comply with the requirements and could not assess the penalty against them.

The court noted that the resolution of the disputes was controlled by its decision in Graev and Chai v. Commissioner, 851 F.3d 190 (2d Cir. 2017). It noted that in all three of the instances in which the IRS sought to assert penalties in this case, the individual proposing the penalties received the personal approval of his or her immediate supervisor. The examiner who proposed the 40% gross valuation misstatement penalty the first time (and the 20% accuracy related penalty in the alternative) received personal written approval from her group manager. Likewise, the appeals office received personal written approval from the team manager for the 40% gross valuation misstatement penalty and for the 20% penalty that was shown on the notice of deficiency. The senior counsel who pleaded affirmatively in the IRS answers that Husband and Wife were liable for the 40% gross valuation misstatement penalty received the associate area counsel's personal written approval. As a result, no matter which of the three instances was the initial determination of the 40% penalty, the requirements of Section 6751(b) were satisfied. As a result, the petitioners were liable for the 40% gross valuation misstatement penalty.

The court also determined that Husband and Wife were not entitled to deduct in 2007 the repayments of state tax credits that were made in 2013 and 2014. Section 1341(a) has three requirements. The first is that the item must have been included in gross income for a prior taxable year or years because it appeared that taxpayer had the unrestricted right to it. The second is that the deduction is allowable for the taxable year at issue because it was established after the close of such prior taxable year or years that the taxpayer did not have an unrestricted right to it. The third is that the amount of such deduction exceeds $3,000. These requirements were not met for the year 2007.

31. <u>Wendell Falls Development, LLC v. Commissioner</u>, T.C. Memo 2018-45

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

The IRS disallowed an income tax charitable contribution deduction of $1,798,000 for the contribution of a conservation easement by Wendell Falls LLC. The IRS also sought to impose a 40 percent penalty for a gross valuation misstatement or, in the alternative, a 20 percent penalty for a substantial valuation misstatement. Wendell Falls, as part of a planned unit development in Wake County, North Carolina, intended to develop 1,280 acres. It also identified 125 acres of the 1,280 acres as the land upon which a park would be placed. In late 2006, the Wake County Board of Commissioners authorized the county to buy the 125 acres identified on the map as a park. Because of an incorrect reference in the planned unit development to the park having 160 acres as opposed to 125 acres, the purchase agreement inadvertently stated that the acreage of the planned park was 160 acres. The purchase agreement also stated that placing a mutually agreeable conservation easement on the land was a precondition to the sale. After realizing the mistake and having a new appraisal done, the land was valued at $3,020,000 unrestricted by any conservation easement and the Wake County Board of Commissioners reauthorized the purchase. On June 7, 2007, a conversation easement on the 125 acres was placed on the property and subsequently a general warranty deed was recorded transferring ownership of the 125 acres from Wendell Falls to Wake County.

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

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

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

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

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

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

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

GENERATION-SKIPPING TRANSFER TAX

33. Letter Ruling 201750014 (Issued September 12, 2017; Released December 15, 2017)

Extension of time granted to sever a marital trust into exempt and non-exempt trust and to make a reverse QTIP election

Decedent’s will provided for the creation of a bypass trust and a marital trust at his death. The marital trust qualified for QTIP treatment. Upon Decedent’s death, the personal representative retained an accountant to prepare the Form 706. On Schedule M of the Form 706, the personal representative made the QTIP election with respect to the marital trust. However, the accountant failed to advise the personal representative to divide the marital trust into exempt and non-exempt marital trusts and to make a reverse QTIP election in order to allocate Decedent’s remaining GST exemption to the exempt marital trust.

The personal representative’s error was discovered when the surviving spouse hired a second attorney to plan her estate. Consequently, an extension of time was requested to sever the marital trust into a GST exempt marital trust and a non-exempt marital trust and to make a reverse QTIP election to allocate Decedent's remaining GST exemption to the exempt marital trust.

The IRS granted the request for an extension of time. Under Treas. Reg. § 301.9100-3, an extension of time will be granted when the taxpayer can establish that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith when the taxpayer reasonably relied on a qualified tax professional to make an election. The requirements for this regulation were satisfied in this case. Decedent's estate was granted an extension of time to sever the marital trust into exempt and non-exempt marital trusts and to make a reverse QTIP election with respect to the exempt marital trust. In addition, the automatic allocation rules of Section 2632(e) would apply to automatically allocate the unused GST exemption to the exempt marital trust.

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

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

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

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

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

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

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

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

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

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

36. Letter Ruling 201747002 (Issued August 9, 2017; Released November 24, 2017)

Executor granted extension of time to allocate decedent's GST exemption to family trust

When Decedent died, Decedent's will created both a family trust and a marital trust. The family trust received a certain dollar amount of assets and had GST tax potential. An accounting firm prepared and filed the Form 706. On the Form 706, the accounting firm allocated X dollar amount of Decedent's GST exemption to the "family QTIP trust." As a result, the accounting firm failed to properly allocate the dollar amount of Decedent's available GST exemption to the family trust.

Decedent's estate requested an extension of time to allocate Decedent's available GST exemption to the family trust. Treas. Reg. § 301.9100-3 provides that an extension of time will be granted when a taxpayer shows that the taxpayer acted reasonably and in good faith and that granting a relief will not prejudice the interests of the government. The regulation also provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election. These requirements were met in this letter ruling and the IRS granted an extension of time to allocate Decedent's GST exemption to the family trust.

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

Estate granted an extension of time to allocate GST exemption

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

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

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

Extension of time to allocate GST exemption granted

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

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

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

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

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

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

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

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

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

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

40. Letter Ruling 201736017 (Issued June 1, 2017; Released September 8, 2017)

IRS permits an extension of time to elect out of the automatic allocation rules with respect to GST tax

Grantor and grantor's spouse established an inter vivos irrevocable trust for the benefit of their three children. Each of the trusts had the potential for the imposition of GST tax. An accounting firm discussed and advised the grantor of the automatic allocation of GST exemption rules and the ability to elect out. The accounting firm prepared the gift tax returns that included an election out of the automatic allocation rules for the current gifts and all future gifts to the trust. As a result of errors by the accounting firm, however, the gift tax return was not timely filed. Consequently, the grantor failed to elect out of the automatic allocation rules for the gifts to the trusts.

Grantor requested an extension of time to elect out of the automatic allocation rules The IRS granted the request for an extension of time to elect out of the automatic allocation rules. It found that the requirements of Treas. Reg. § 301.9100-3 were met. Under this Treasury Regulation, a request for relief will be granted when the taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied upon a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

41. Letter Ruling 201737006 (Issued June 12, 2017; Released September 15, 2017)

Extension of time to opt out of automatic allocation rules for GST exemption permitted

Taxpayer created an irrevocable family trust after December 31, 2000 that had the potential to be subject to GST tax. On the same date, taxpayer established a grantor retained annuity trust. Under the terms of the grantor retained annuity trust, taxpayer's retained interest terminated and any remaining principal passed to the family trust at the end of the second year. For GST tax purposes, the estate tax inclusion period for the grantor retained annuity trust closed on the date of the termination of the grantor's annuity interest. The taxpayer did not intend for the family trust to benefit the grandchildren and did not intend to allocate as GST exemption to the transfers to the GRAT and family trust.

The taxpayer engaged an accounting firm to prepare all the federal and state tax filings. The accounting firm inadvertently reported the transfers to the GRAT and family trust on Schedule A, Part 1 of the gift tax return (gifts subject only to gift tax) instead of Schedule A, Part 3 (indirect skips). In addition, the accounting firm failed to advise the taxpayer of the opportunity to elect out of the automatic allocation rules for the GST exemption. The taxpayer requested an extension of time to opt out of the automatic allocation rules. The Service held that Treas. Reg. § 301.9100-3 would apply. Under this regulation, a request for relief will be granted when the taxpayer provides evidence that the taxpayer acted reasonable and in good faith and that the grant of the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a tax professional.

42. Letter Ruling 201737007 (Issued June 1, 2017; Released September 15, 2017)

IRS permits taxpayer to opt out of automatic allocation GST exemption

Grantor and grantor's spouse establish an inter vivos irrevocable trust for the benefit of each of their three children. Each trust had the potential for GST tax. An accounting firm discussed and advised the grantor about the rules regarding the automatic allocation of GST exemption and the ability to elect out of those rules. The accounting firm prepared a gift tax return that included an election out of the automatic allocation of GST exemption. However, the accounting firm failed to file the gift tax return on time and therefore the opt-out of the automatic allocation failed.

The grantor requested an extension of time to elect out of the automatic allocation rules. The Service granted the request, citing Treas. Reg. § 301.9100-3. That regulation provides that requests for relief will be granted if the taxpayer shows that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional.

43. Letter Rulings 201743004 and 201743005 (Issued July 3, 2017; Released October 27, 2017)

IRS allows extension to elect out of the automatic allocation of GST exemption rules

Taxpayer created a trust for the benefit of his descendants and family members prior to January 1, 2001. The trust had GST tax potential. Taxpayer made an annual transfer to the trust and its successor in each year from Year 1 through Year 13. In reporting the transfers, Taxpayer and Taxpayer's Spouse split the gifts. The gifts were reported on a timely filed Form 709.

The returns filed for Year 1 and Year 10 include election out statements, providing that Taxpayer was electing out of the automatic allocation of GST exemption with respect to the gifts to the trust. However, the returns filed for Year 2 through Year 9 did not include the election out statements to avoid the automatic allocation of GST exemption. Subsequently in Year 11, Taxpayer created Trust B for the benefit of his issue. Trust B had GST tax potential. On the same date, the trustee of Trust A exercised the power provided under state law to transfer the Trust A principal to Trust B, and the Trust A principal thereupon became the principal of Trust B. Taxpayer made an annual transfer to Trust B in each of Year 11 through Year 13. These gifts to Trust B were split by Taxpayer and Taxpayer's Spouse. These returns did not include an election out statement to avoid the automatic allocation of GST exemption to the transfers that Trust B reported.

Taxpayer requested an extension of time to have the automatic allocation rules not apply to the transfers made to Trust A and Trust B for the years in question. An extension of time to opt out of the automatic election rules will be granted under Treas. Reg. § 301.9100-3 when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

In this situation, the government concluded that Taxpayer's returns filed for Year 1 and Year 10 included effective elections out of the automatic allocation rule with respect to the gifts reported therein. Furthermore, the taxpayer was granted an extension of time to make the opt-out election for Year 2 through Year 9 and for Year 11 through Year 13.

44. Letter Rulings 201731005 and 201731010 (Issued April 3, 2017; Released August 4, 2017)

Taxpayer found to have complied with the essential requirements necessary to allocate GST exemption to irrevocable trust

These two letter rulings have the same facts. Husband created an irrevocable trust for the benefit of his descendants. Husband and Wife hired an attorney to prepare the gift tax returns. On each return, Husband and Wife signed their consent to treat the transfers as having been made one half by each spouse under Section 2513. Husband elected out of the automatic allocation rules with respect to the gift to the trust that year. The attorney preparing the gift tax return for Husband correctly reported the transfer to the trust as an indirect gift. The attorney also allocated GST exemption to the transfer on Schedule B, Part 2, line 6; however the attorney failed to attach a Notice of Allocation for this transfer. Because Husband elected out of the automatic allocation rules, Husband could still allocate GST Exemption by properly reporting the allocation on a timely filed gift tax return which Husband did. Husband failed to attach a Notice of Allocation of GST Exemption in accordance with the instructions for Form 709. As a result, Husband failed to literally comply with the instructions for the gift tax return or with the requirements and the regulations for allocating GST exemption to an indirect skip in accordance with Section 2632(c).

The ruling noted that literal compliance with the procedural instructions to make an election is not always required. Elections may be treated as effective where the taxpayer complied with the essential requirements of the regulations (or the instructions to the applicable form) even though the taxpayer failed to comply with certain procedural directions therein. Hewlett Packard Company v. Commissioner, 67 T.C. 736 (1977). As a result, the Service ruled that the gift tax return submitted by Husband contained sufficient information to constitute substantial compliance with the requirements of Section 2632(c) to allocate GST exemption to an indirect skip and, therefore, Husband allocated GST exemption to the transfer to the trust.

45. Letter Ruling 201735009 (Issued May 25, 2017; Released September 1, 2017)

Judicial reformation of trust will not subject the trust to GST tax

This letter ruling involved a pre-1985 grandfathered GST irrevocable inter vivos trust that was for the primary benefit of Son and Son's issue. Pursuant to a power to amend the trust, a trust committee amended the trust several times prior to September 25, 1985. The committee also amended the trust subsequently to September 25, 1985. One change made by one amendment to add an additional relative of the grantor as a beneficiary would arguably extend the term of the trust. Subsequently, the trustees of the trust sought a judicial construction of the effect of the amendment adding the additional relative, to specifically find that the addition of the relative as a contingent beneficiary would not add the relative as a measuring life in determining the duration of the trust, and under the state common law rule against perpetuities, the amendment was void ab initio and that state law prohibited the use of the additional relative from being a measuring life. The court construed the trust as requested.

The trustee now requested a ruling that the amendment to the trust and the subsequent court construction of the trust did not cause the trust to lose its exemption from GST tax. The IRS noted that the amendment to the trust to add the additional relative as a contingent beneficiary created an ambiguity but that the court issue an order construing the amendment to assent to be sure that the additional relative was not treated as a measuring life for purposes of determining the duration of the trust. As a result, the trust would not be subject to additional GST tax and would retain its grandfathered status.

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

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

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

The Service first ruled that the terms of the trust presented a bona fide issue regarding whether an adopted grandchild of the Settlor was considered a member of the class of issue, descendants, or children. It also ruled that the State Court's order construing the ambiguous terms was consistent with the applicable state law that would be applied by the highest court of the state. The Service here followed Treas. Reg. § 26.2601-1(b)(4)(i)(C) which provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument to correct a scrivener's error will not cause an exempt trust to be subject to the generation skipping tax if the judicial action involves a bona fide issue and the construction is consistent with the applicable state law that would be applied by the highest court of the state, pursuant to Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). Here the declaratory judgment met the requirements of the Treasury regulations and the construction of the trusts would not affect its exempt status.

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

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

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

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

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

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

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

Modification of GST grandfathered trust will not affect exempt status

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

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

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

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

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

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

The executors engaged a law firm to prepare a Form 706. An accounting firm was retained to advise the estate on income tax issues arising as a result of decedent's death. Neither the law firm nor the accounting firm advised decedent's estate of any gifts or distributions to grandchildren that would have a GST impact. Moreover decedent's estate was not advised to divide the residuary trust into separate exempt and non-exempt trusts to effect decedent's GST planning. The estate tax return was timely filed but did not evidence any attempt to divide the residuary trusts into exempt or non-exempt trusts. The executors requested an extension of time to sever the residuary trust into exempt and non-exempt trusts and a ruling that the automatic allocation rules would cause any unused portion of decedent's GST exemption to be allocated to the exempt residuary trust.

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

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

50. Letter Ruling 201732029 (Issued April 20, 2017; Released August 11, 2017)

Reformation of grandfathered GST Trust to correct scrivener's error will have no adverse estate, gift, or generation-skipping tax consequences

Decedent created an irrevocable trust prior to September 25, 1985 and thus the trust was grandfathered from GST tax. Under the terms of the trust, the income and principal of the trust was to be available for the son of the decedent and son's children during the lifetime of son. Upon the death of the son, the assets of the trust would to be divided into separate trusts equal in number to the then surviving children of son until each child reached the age of 30 years at which time one-half of the principal of the trust would be distributed to the child with the balance being distributed to the child at age 35. Son had three children of whom two children were now living and one child was deceased. The deceased child left three children of her own. As a result of a scrivener's error, upon son's death, the children of the predeceased granddaughter would not receive a distribution from the trust. In order to correct the scrivener's error, the trustee petitioned the county court to reform the provisions of the trust by removing the word "surviving" from the paragraph of the trust with respect to distributions to the son's children upon the death of the son.

Three rulings were requested:

- The proposed court reformation could not cause the trust to have any adverse GST tax liability;
- The proposed reformation would not result in any gift tax liability to the beneficiaries; and
- The proposed reformation would not result in any estate tax liability to the beneficiaries.

The IRS held that the court reformation would have no adverse tax consequences. It found that the reformation of the trust was consistent with applicable state law that would be applied in the highest court of the state. As a result, the proposed reformation would not cause the trust to lose its GST exempt status under Section 2601 or result in any GST tax liability to any beneficiary of the trust. Under Treas. Reg. § 26.2601-1(b)(4)(i)(C), a judicial construction of a governing instrument will not cause an exempt trust to be subject to GST tax if the judicial action involves a bona fide issue and the construction is consistent with applicable state law that would applied by the highest court of the state. Those conditions were met. The IRS also ruled that the proposed court reformation would have no estate or gift tax liability to the beneficiaries.

51. Letter Ruling 201735005, (Issued May 8, 2017; Released September 1, 2017)

Inadvertent payment by trust beneficiary of federal and state income taxes will not have adverse estate, gift, or GST tax consequences

This letter ruling involved a lifetime grandfathered GST irrevocable trust created prior to September 25, 1985. The trust was for the benefit of daughter and her issue. The trust was funded with shares of stock in an S corporation and was a qualified subchapter S trust.

Subsequent to the creation of the trust, the trustee sold the trust's shares of stock in the S corporation in a transaction that resulted in capital gains to the trust for federal and state tax purposes. Pursuant to state law, the capital gains should have been allocated to trust principal and all income taxes due on the capital gains were required to be paid from trust principal. However, the trustee issued a Schedule K-1 to the daughter which treated the capital gains as a taxable distribution to the daughter for both federal and state tax purposes.

After receiving the Schedule K-1 the daughter reported the entire amount of the capital gains on her individual federal and state income tax returns which she jointly filed with a spouse. The errors on the schedule K-1 were in Year 1. The trustee made an additional distribution to daughter in year 2 as a partial reimbursement for the income taxes erroneously paid by daughter and spouse. The daughter did not waive the right of recovery with respect to the erroneous payment of income taxes in Year 1.

The trustee subsequently prepared a draft of its first accounting. Upon receipt of the draft accounting, daughter became aware that she was due an additional reimbursement from the trustee for the income taxes that she and her spouse in connection with the sale of the S corporation stock. The daughter sought a court order to have the trustee reimburse her spouse and her for the income taxes they paid in error.

The daughter also requested a ruling from the IRS that the inadvertent payment by the daughter of the federal and state income taxes would not constitute a constructive addition to the trust for generation skipping tax purposes and that the subsequent reimbursement to the daughter of the income taxes paid together with interest and attorney's fees would not cause any portion of the trust to be subject to GST tax. Rulings were also requested that the inadvertent payments would have no adverse estate and gift tax consequences.

The IRS ruled that there was no constructive addition to the trust for GST purposes that would cause the trust to lose its exemption. It noted that the daughter did not waive her right to recovery and petitioned the court to reimburse her for unreimbursed income taxes with interest and penalty and the Trustee had agreed to reimburse the daughter. Consequently, no addition to the trust occurred as a result of the daughter's inadvertent payment of the income taxes and the trust's prior reimbursement of income taxes and subsequent reimbursement under the court order for the income taxes together with interest and payment.

Also, since there was no change in beneficial interest or the beneficiaries and no transfer of property had occurred as a result of the inadvertent payment of the income tax and the reimbursement of income taxes, daughter did not make a gift to the trust for gift tax purposes.

Finally, since daughter did not transfer any property to the trust, Section 2036 would not apply to cause any property in the trust to be included in daughter's estate at her death since in order for Section 2036 to apply, there must be a transfer.

FIDUCIARY INCOME TAX

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

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

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

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

Prior to August 20, 1996, the trust was treated as a grantor trust for income tax purposes; however, as a result of the Small Business Job Protection Act in 1996, which became effective on August 20, 1996, the grantor trust rules only apply in computing the income of a citizen or resident of the United States. There was an exception that provides that a trust would be treated as a grantor trust if during the lifetime of the grantor distributions could only be made to a non-citizen grantor or the non-citizen spouse. As a result of the Small Business Job Protection Act, after August 20, 1996, the trust was no longer a grantor trust.

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

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

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

IRS grants extension to trust for charitable contribution election

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

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

54. Green v. United States, 880 F.3d 519 (10th Cir. January 12, 2018)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

55. Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue, ____ N.C. ____ (2018)

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

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

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

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

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

It has long been settled that a trust has a separate existence from its beneficiary, and therefore income to the trust is separately attributed. In determining whether the statute is constitutional, as applied to the trust, the North Carolina Supreme Court evaluated the requirements of the due process clause, specifically that the entity being taxed must "purposefully direct its activities" at the state, and the activities must be sufficiently abundant that the entity invokes the benefits and protections of that state's laws. Therefore, in order to withstand this challenge, the presence of the trust beneficiary in the state must satisfy the "purposeful" requirement to allow taxation of the trust. The North Carolina Supreme Court concluded that the unilateral activity of the beneficiary did not satisfy this requirement.

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

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

56. Fielding v. Commissioner, ____ Minn. ___ (July 18, 2018)

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

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

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

The Minnesota Commissioner of Revenue denied the refund claims and the Commissioner's decision was appealed to the Minnesota Tax Court on the grounds that the Minnesota statute violated the due process and commerce clauses of the United States and Minnesota constitutions. The trusts and the Commissioner each moved for summary judgment. The Minnesota Tax Court ultimately concluded that defining the trust as a resident trust based upon Reid MacDonald's

Minnesota residency at the time the trusts became irrevocable violated the due process provisions of the Minnesota and United States constitutions. The Minnesota Tax Court stated that the grantor's domicile at the time the trust becomes irrevocable was not "a connection of sufficient substance" to support taxing the trusts. Having decided the case on due process grounds, the Minnesota Tax Court did not reach the Commerce Clause.

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

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

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

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

The trusts, on the other hand, noted that:

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

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

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

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

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

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

57. Notice 2018-61, 2018-31 IRB (July 13, 2010)

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

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

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

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

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

New Section 67(g) of the Code suspends the deduction for miscellaneous itemized deductions for any taxable year beginning after December 31, 2017, and before January 1, 2026. Some practitioners expressed concern that Section 67(g) may inadvertently eliminate the ability of an estate or nongrantor trust to deduct the administration expenses described in Section 67(e)(1).

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

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

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

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

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

ASSET PROTECTION

58. Georgia House Bill 441

Georgia Governor vetoes domestic asset protection trust legislation

In late March, the Georgia House of Representatives (by a vote of 103-56) and the Georgia Senate (by a vote of 43-6) passed HB 441, which would have made Georgia the 18th state to permit self-settled domestic asset protection trusts or DAPTs. Currently, 17 states — Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming — have enacted DAPT-enabling legislation. Georgia, however, did not join their ranks, because on May 8, Gov. Nathan Deal vetoed HB 441.

Under current Georgia law, spendthrift provisions in a trust that shield the trust's assets from certain creditors are enforceable if the trust is settled by someone other than the trust's beneficiaries. HB 441 would have gone further, as the other DAPT states have done, by providing creditor protections to an irrevocable trust even if the settlor is also a beneficiary of the trust.

Deal indicated in his veto statement that he was open to further negotiations on this issue. However, the version of the bill Georgia's governor rejected already contained remarkably large gaps in the creditor protection that HB 441 supposedly would have provided. Tort, child support, and spousal claims, for instance, were completely exempted. Secured creditors also enjoyed an exemption for assets specifically pledged by a debtor. That left credit card and medical claims as perhaps the only types of debt that HB 441 would have allowed a settlor to avoid.

It is also worth noting that, with this veto, Deal has strengthened Georgia's standing as one of the most creditor-friendly states in the country. Further, in 2015, Georgia enacted the Uniform Voidable Transfer Act (UVTA). Under the UVTA, creditors may avoid certain transfers made by an insolvent debtor by using the less-onerous preponderance-of-the-evidence standard, as opposed to the clear-and-convincing standard used in many jurisdictions. The UVTA also makes it more difficult for debtors, and the trusts they settle, to start the statute-of-limitations clock for allegedly voidable transfers.

Deal's veto of HB 441 appears to continue Georgia's generally creditor friendly legal tradition.

59. Toni 1 Trust v. Wacker, ___ AK ___ (March 2, 2018)

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

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

In 2010, before the issuance of the last of the default judgments, Toni Bertran and Barbara Tangwall transferred parcels of real property to an Alaskan trust called the “Toni 1 Trust” which was an Alaska self-settled domestic asset protection trust.” The Wackers filed a fraudulent transfer action under Montana law in Montanan state court alleging that the transfers were fraudulent and default judgments were entered against Barbara Tangwall, the Toni 1 Trust, and Toni Bertran.

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

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

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

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

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

60. In re Olson, ___ F. Supp. 3d ___ (C.D. Cal 2018)

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

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

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

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

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

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

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

FIDUCIARY CASES

61. In re Matter of the Estate of Anne S. Vose v. Lee, 390 P.3d 238 (Okla. Jan. 17, 2017)

Decedent's executor had a fiduciary obligation to the surviving spouse to file an estate tax return to elect portability of the deceased spousal unused exclusion amount even though under a premarital agreement the surviving spouse was not an heir or distributee of the decedent's estate

Facts: Anne S. Vose (the "Decedent") died intestate on January 22, 2016. The Decedent and her surviving spouse, C.A. Vose, Jr. ("Vose"), had entered into a premarital agreement on May 24, 2006 (the "Premarital Agreement"). Under the Premarital Agreement, Vose relinquished all his rights to take as an heir or distributee from the Decedent's estate.

After concluding a dispute regarding the validity of a purported will the Decedent had executed in 1995, the District Court of Oklahoma County, Oklahoma, appointed Robert E. Lee, III ("Lee"), the Decedent's son from a previous marriage, as the Decedent's intestate administrator.

Through a principle known as "portability," Section 2010 of the Internal Revenue Code allows the executor of the estate of a deceased spouse, or certain other individuals, to make an election to allow the surviving spouse to use the deceased spouse's unused estate tax exemption (the "DSUEA"), for purposes of the surviving spouse's gifts during life and upon death.

On August 10, 2016, Vose filed an application to the District Court asking the Court to compel Lee to file an estate tax return to elect portability. The District Court granted the application.

Lee appealed, alleging that (1) the District Court lacked subject matter jurisdiction, (2) federal law preempted the District Court's order, (3) Vose lacked standing because of the Premarital Agreement, and (4) the District Court's order violated the Premarital Agreement.

Law: Congressional preemption of state law occurs when:(1) express statutory language indicates Congress intends to preempt state law, (2) the existence of a pervasive regulatory scheme implies Congress intended for federal law to occupy the field, (3) it is impossible to comply with both state and federal law, or (4) state law thwarts the purposes of federal law.

Under Oklahoma law, standing in a probate proceeding requires the party have a pecuniary interest in the decedent's estate. Standing does not necessarily require an interest as an heir or distributee, but requires only a financial interest in the outcome of the dispute concerning the decedent's estate.

Under Oklahoma law, a premarital agreement is generally effective to waive marital rights to property, whether created by statute or otherwise. However, under Oklahoma law, a contract cannot waive future rights of which the parties have no actual or constructive knowledge or notice.

According to Oklahoma law, an executor or administrator has a fiduciary obligation to all parties interested in the estate to administer faithfully the estate's property and preserve it from damage, waste, and injury.

Holding: The Supreme Court of Oklahoma upheld the District Court's order requiring Lee to file an estate tax return to elect portability. The Supreme Court held that Section 2010 of the Internal Revenue Code does not preempt Oklahoma law. Nothing in Section 2010 demonstrates Congressional intent for federal law to occupy the field of fiduciary obligations with respect to tax elections, supplants Oklahoma law governing the fiduciary obligations of an executor or administrator, or makes it impossible for a fiduciary to comply with both Oklahoma law and the federal requirements of making the portability election. The District Court did not lack subject matter jurisdiction over Vose's petition and federal law did not preempt the District Court's order because Vose's claims concerned only Lee's state law fiduciary obligations.

The Supreme Court also held that Vose possessed standing to file his application to compel Lee to elect portability. Although Vose waived his rights as an heir and distribute of the Decedent's estate in the Premarital Agreement, the portability election still had pecuniary value to Vose. The Court held that Vose did not waive his right to the DSUEA in the Premarital Agreement because the DSUEA did not exist at the time Vose and the Decedent executed the Premarital Agreement. Finally, the Supreme Court held that the District Court could compel Lee to file an estate tax return to elect portability of DSUEA because Lee had a fiduciary obligation to all persons interested in the estate, not just the estate's distributees.

In its analysis, the Court treated the DSUEA as an asset of the Decedent's estate that Lee, as the administrator, had a duty to protect. The Supreme Court also upheld the District Court's order requiring Vose, rather than the estate, to pay the costs of preparing and filing the estate tax return.

Practice Point: Under Oklahoma law, the DSUEA may now be a property right of the surviving spouse. Accordingly, practitioners representing couples whose net worth exceeds the federal basic exclusion amount should address the DSUEA in any marital or premarital agreements, as well as in estate-planning documents.

Practitioners should also consider amending existing marital agreements to incorporate provisions addressing the DSUEA. Marital agreements and estate-planning documents should explicitly state whether a spouse is waiving portability of the DSUEA, whether the executor of the first spouse to die has a duty to elect portability, and who should bear the cost of electing portability.

The Supreme Court also held that Lee owed fiduciary duties not just to the estate's beneficiaries, but also to "all parties having an interest in the estate." When drafting estate-planning documents, practitioners should also consider stating explicitly that the executor or trustee owes no fiduciary duties to a surviving spouse who is not otherwise a beneficiary merely because the fiduciary's decision whether or not to elect portability affects the surviving spouse.

62. Du Pont v. Wilmington Trust Company, C.A. No. 12839-VCS (Del. Ch. Oct. 6, 2017)

Delaware Chancery Court refuses to grant trust beneficiary's petition to remove the trustee of five directed trusts when the grounds for removal did not relate directly to matters of trust administration

Facts: Douglas W. du Pont ("du Pont") was the beneficiary of four trusts created under agreement and one under a will (collectively, the "Trusts") for the benefit of himself and his descendants. Wilmington Trust Company, N.A. ("Wilmington Trust"), was the trustee of the trusts and had been since inception of the Trusts in the 1940s and 1950s. Each of the Trusts were total return unitrusts governed by Delaware law. At the inception of the Trusts, Wilmington Trust was closely associated with the du Pont family, many of whose members participated in the management of Wilmington Trust. During the 2008 financial crisis, Wilmington Trust was the subject of government investigations and litigation. M&T Bank, a New York corporation, subsequently acquired Wilmington Trust. No du Pont family members remained involved in the management of Wilmington Trust after the acquisition.

In 2013, du Pont became dissatisfied with the investment performance of the Trusts and requested that Wilmington Trust petition the Delaware Court of Chancery (the "Court") to amend the Trust instruments to incorporate directed trustee provisions. Wilmington Trust complied with du Pont's request. The Court granted Wilmington Trust's petition and appointed du Pont as the investment director of each of the Trusts.

In addition to serving as trustee of the Trusts, Wilmington Trust also advised du Pont regarding his personal estate planning. At the advice of Wilmington Trust, du Pont made gifts to irrevocable trusts for his children naming Wilmington Trust as trustee. Du Pont claimed he would not have made these gifts had Wilmington Trust informed him that the trusts did not include his wife as a permissible beneficiary. Wilmington Trust also made loans to du Pont, and du Pont pledged personal assets as collateral for these loans. When du Pont became unable to repay the loans, Wilmington Trust reduced his unitrust payout and liquidated low-basis assets to reduce the principal balance of the loans. The liquidation of the low-basis assets resulted in millions of dollars of capital gains tax.

In February 2016, du Pont requested that Wilmington Trust resign as trustee of the Trusts. Wilmington Trust refused his request. The governing instruments of the Trusts contained no provision governing trustee removal. Consequently, in October 2016, du Pont petitioned the Court for removal of Wilmington Trust.

In support of his petition for removal, du Pont alleged that (1) there was a substantial change in circumstances since Wilmington Trust was appointed trustee, (2) hostility between Wilmington Trust and du Pont interfered with proper administration of the Trusts, and (3) Wilmington Trust was unfit, unwilling, and unable to administer the Trusts because it miscalculated the amount of his unitrust distribution, did not sufficiently communicate with him, and rejected his reasonable request for money to cover tax liabilities. Wilmington Trust filed a motion to dismiss du Pont's petition for failing to state a claim for relief.

Law: Under 12 Del. C. § 3327(3), the Court may remove a trustee, even in the absence of a breach of trust, when (1) there has been a substantial change in circumstances, (2) the trustee is unfit, unwilling, or unable to administer the trust properly, or (3) when hostility between the trustee and beneficiaries threatens the efficient administration of the trust. The Court must have "due regard for the expressed intention of the trustor and the best interests of the beneficiaries."

In a case of first impression, the Court used the official comment to Section 706 of the Uniform Trust Code to interpret the meaning of "changed circumstances" under Delaware law. Changed circumstances for this purpose include a "change in the character of the service or location of the trustee" but do not include the "corporate reorganization of an institutional trustee."

Under Delaware law, a trustee is "unwilling" or "unable" to administer the trust properly when the trustee refuses to act or "exhibits a pattern of indifference." A trustee is "unfit" to act when the trustee does not treat the beneficiaries fairly or commits a breach of trust. Under Delaware law, a beneficiary's lack of confidence in the trustee or the existence of friction is not grounds for removal. A court may remove a trustee only when the hostility makes it impossible for the trustee to perform its duties.

Holding: The Court held that du Pont did not plead sufficient facts to state a claim for relief. M&T's acquisition of Wilmington Trust did not constitute a change of circumstances warranting Wilmington Trust's removal. According to the Court, du Pont failed to state how government investigations into Wilmington Trust's activities prevented it from discharging its duties as a trustee.

Additionally, Wilmington Trust did not exhibit a "pattern of indifference." Even though Wilmington Trust was a directed trustee with respect to investment decisions, it retained discretion over distribution decisions. The instruments for the Trusts required Wilmington Trust to consider beneficiaries' other resources when making distributions. Accordingly, Wilmington Trust acted within its discretion not to distribute funds to du Pont for tax liabilities. Furthermore, errors in calculating the unitrust payment did not amount to indifference.

The Court held that even if Wilmington Trust acted negligently in giving estate planning advice to du Pont, he failed to allege how negligent estate planning advice impacted Wilmington Trust's performance of trustee services. The Court also held that Wilmington Trust loaned money to du Pont under commercially reasonable terms and the loans did not amount to unfair treatment.

Finally, the Court held that du Pont failed to allege sufficient facts to show that friction between du Pont and Wilmington Trust made it impossible for Wilmington Trust to manage effectively the Trusts.

Practice Point: Delaware courts are unlikely to grant a petition to replace a trustee when the reasons given for the requested removal do not relate directly to issues of trust administration. In order to avoid uncertain and protracted court disputes, drafters of estate planning documents should also include provisions governing the resignation or removal of trustees and specify the circumstances under which a beneficiary may remove a trustee.

63. Saccani v. Saccani, No. C078958, 2016 WL 6068962 (Cal. Ct. App. Oct. 17, 2016)

California court interprets a shareholder agreement to permit a shareholder's pre-death transfer of shares to a revocable trust after that shareholder gave another shareholder the option to purchase the shares after the transferring shareholder's death, even though the shareholder agreement itself only authorized share transfers to trusts for the benefit of a shareholder's descendants

Facts: Donald, Ronald, and Gary Saccani inherited equal one-third interests in Saccani Distributing Company (the "Company") from their father, Albert Saccani. On December 30, 1991, Donald, Ronald, Gary, and each of their wives entered into the Second Amended and Restated Stock Purchase Agreement of the Company (the "Shareholder Agreement"). Section 1.01 of the Shareholder Agreement stated that "[n]o Shareholder shall gift, sell, pledge, encumber, hypothecate, assign or otherwise dispose of (collectively 'Transfer')" any interest in the Company unless permitted by the Shareholder Agreement. Section 1.02 of the Shareholder Agreement allowed the shareholders to make "Permitted Transfers" to each other, their descendants, and to estate planning trusts for their descendants. At the death of a shareholder, Section 3.02 of the Shareholder Agreement caused a deemed sale of the deceased shareholder's shares to the Company unless a Permitted Transfer occurred.

Donald Saccani and his wife Phyllis transferred all their shares in the Company to a revocable trust that gave Gary Saccani the option to purchase all of Donald's shares after Donald's death. Donald died in 2007, and Gary exercised the option granted under Donald's revocable trust in 2012.

In 2013, Ronald died, and his children Todd and Antonio Saccani inherited his shares in the Company. Todd and Antonio sued Gary, Gary's wife Jill, Donald's wife Phyllis, the trustee of Gary and Jill's revocable trust, and the trustee of Donald and Phyllis's revocable trust in California Superior Court, alleging that the transfer of Donald's shares to Gary violated the Shareholder Agreement.

Todd and Antonio argued that Section 1.02 of the Shareholder Agreement did not permit Donald to give Gary an option to purchase shares held in Donald's revocable trust agreement, because Section 1.02 only permitted transfers to estate planning trusts for the benefit of a shareholder's descendants. Accordingly, at Donald's death, a deemed sale of his shares to the Company should have occurred. Disagreeing with Todd and Antonio's reading of the Shareholder Agreement, the Superior Court found for the defendants. Todd and Antonio appealed.

Law: Under California law, a court should give effect to the mutual intent of the parties when interpreting a contract. When the language of a contract is clear, a court should determine intent from the language of the contract. If a contract does not provide specialized definitions for terms, a court should use the ordinary meaning of words when analyzing the contract.

Holding: The Third District Court of Appeal of California (the "Court") affirmed the Superior Court's decision and held that the option granted to Gary was a Permitted Transfer under the Shareholder Agreement. Section 1.01 of the Shareholder Agreement defined "Transfer" to include any attempt to "gift, sell, pledge, encumber, hypothecate, assign or otherwise dispose of" shares in the Company. The Court stated that, by granting Gary an option to purchase shares of the Company after his death, Donald had encumbered the shares. The act of encumbering the shares was a "Transfer" to Gary within the meaning of Section 1.01 and was a "Permitted Transfer" within the meaning of Section 1.02 because Gary was another shareholder of the Company. Accordingly, it did not matter that Section 1.02 restricted transfers to estate planning trusts only for the benefit of a shareholder's descendants, because a "Transfer" to Gary had taken place during Donald's lifetime. Furthermore, Section 3.02 allowed a Permitted Transfer to take effect at Donald's death, not just during Donald's lifetime.

Practice Point: When drafting or interpreting shareholder agreements (and contracts in general), advisors should pay careful attention to definitional provisions and how those definitions apply when used in all places in the agreement. Advisors should consider multiple factual scenarios and the effect of the definitions under each of those scenarios. The advisor's goal should be to make sure that under any scenario the definitions conform to the parties' intent and do not cause unintended results.

64. <u>Gray v. Binder</u>, 805 S.E.2d 768 (2017)

The Commissioner of Accounts had the authority to hear a petition filed by the administrator of an estate for advice and guidance regarding the interpretation of the will and the determination of the proper heirs of the decedent

Facts: Albert F. Bahnfleth died testate on July 19, 2012. His will, executed in 1966, was admitted to probate in the Circuit Court for Fairfax County, Virginia. Each of the named beneficiaries in Bahnfleth's will predeceased the decedent.

In Virginia, oversight of certain fiduciaries is conducted by the Commissioner of Accounts, an official who assists the local circuit court. The Administrator of Bahnfleth's estate requested guidance from, and a hearing before, the Commissioner of Accounts of Fairfax County, regarding the determination of the decedent's heirs and the interpretation of the will.

Under Virginia law, Bahnfleth's cousins were his intestate heirs. Steven C. Gray, the step-grandson of Bahnfleth, attended the hearing, claimed that Bahnfleth intended to leave him half of his estate. Bahnfleth's will in fact bequeathed a share of his estate to his step-daughter, and Gray's mother, Jean Gray, with the expressed "desire that [Jean] use it for the education of . . . Steven C. Gray." Bahnfleth's cousins argued that such language was precatory, and showed only an intent to benefit Jean.

In January 2015, the Commissioner issued a report holding that all bequests in Bahnfleth's will had lapsed, and that his estate passed pursuant to the laws of intestacy. Gray filed exceptions to the report, but the Fairfax County Circuit Court overruled the exceptions and entered an order confirming the report. Gray filed a motion to reconsider which the Circuit Court denied, holding that "the Commissioner of Accounts has properly interpreted the law on the applicable facts." The Circuit Court further denied Gray's Petition for Appeal and Petition for Rehearing.

On May 4, 2016, the Commissioner filed a routine debts and demands report with the Circuit Court, authorizing the Administrator to "distribute the remainder of the estate to the beneficiaries after the final payments of any administrative expenses and debts known to the fiduciary." Gray responded to the debts and demands report, and he challenged the jurisdiction of the Commissioner to issue its January 2015 report without an initial decree of reference from the Circuit Court.

The Circuit Court confirmed the May 2016 report. Gray then filed a motion for reconsideration and to vacate the January 2015 report and the May 2016 report. The Circuit Court suspended its order and granted the Commissioner leave to respond to Gray's motion for reconsideration. The Commissioner found that his office was vested with the "authority to hear any matter concerning settlement of a fiduciary's account." Upon the Commissioner's findings, the Circuit Court denied Gray's motion for reconsideration. Gray appealed.

Law: Pursuant to Section 64.2-1200 et seq. of the Code of Virginia, the Circuit Court is vested with jurisdiction over fiduciary matters, including the administration of estates. The office of the Commissioner of Accounts was established "to afford a prompt, certain, efficient, and inexpensive method" for the settlement of fiduciaries' accounts and distribution of estates. Carter's Adm'r v. Skillman, 60 S.E. 775, 776 (Va. 1980). However, the Commissioner serves to assist the court, not supplant it.

Holding: On appeal, the Supreme Court of Virginia considered whether the Commissioner exceeded his authority when, at the request of Bahnfleth's Administrator, he conducted a hearing and produced a report interpreting Bahnfleth's will and determining heirs without an order of reference to consider the request for aid and guidance from the Circuit Court.

The Supreme Court of Virginia held that the Commissioner had authority to interpret the will and determine the heirs without an order of reference from the Circuit Court. The Court held that, contrary to Gray's assertion that the Commissioner has limited probate jurisdiction, the Commissioner's authority with respect to the settlement of estates is an extension of the Circuit Court's jurisdiction. The Court held that the Commissioner of Accounts is not a lower tribunal of limited jurisdiction; instead, it provides supervision within the jurisdiction of the Circuit Court, and, pursuant to Section 64.2-1209 of the Code of Virginia, the Commissioner "may hear and determine any matter which could be insisted upon or objected to by an interested person if the commission of accounts were acting under an order of a circuit court." The Supreme Court of Virginia did not consider the merits of the Commissioner's findings regarding the will and the passing of Bahnfleth's estate intestate, noting that it does not have jurisdiction to review reports provided by the Commissioner of Accounts.

Practice Point: Fiduciaries should be cognizant that the Commissioner of Accounts is a resource to the fiduciary and may be a means of receiving advice and guidance where the fiduciary is unclear regarding the terms of and interpretation of will or trust documents. Particularly in light of this case, the Commissioner of Accounts can provide a practical venue for such guidance.

65. Lawson v. Collins, No. 03-17-00003-CV, 2017 WL 4228728 (Tex. App. Sept. 20, 2017)

An arbitration award is final and binding on all participating parties and has the effect of a court order, regardless of whether all parties agree to the terms of the arbitration award. Absent evidence of statutory grounds for overturning such award, or evidence that such award is the result of fraud, misconduct or gross mistake, an arbitration award will be affirmed and confirmed

Facts: Talferd Gabriel Collins died in 1997. Talferd's wife, Ella Lee Myers Collins, died in 2014, leaving a will dated May 14, 2012. Together they had eleven children. In her will, Ella named three of her eleven children – Boyd, Elizabeth, and Robert – as executors. Following application for probate of the 2012 Will, Alice Lawson (a daughter of Talferd and Ella) filed a petition asserting that (1) the 2012 Will was not valid because Ella lacked legal or testamentary capacity to execute the will and (2) the 2012 Will was executed due to fraud or undue influence of Boyd or Elizabeth. Alice further objected to the appointment of Boyd and Elizabeth as executors, and later amended her petition seeking admission of a supposedly lost will of Ella to probate.

In October 2015, the parties, Boyd, Elizabeth, Ronald, Silas and Alice, participated in mediation, which resulted in a Mediated Settlement Agreement ("MSA") that was signed by each participant in the mediation, the mediator, and the participant's attorneys. The terms of the MSA provided, inter alia, that Alice would withdraw her will contest and that "any disputes as to the wording of settlement documents or performance hereof shall be submitted to the Mediator, Claude Ducloux, for binding arbitration."

Following mediation, the parties were unable to agree on the terms of the longer form settlement and release documents contemplated by the MSA. Alice and Ronald refused to sign the settlement documents and refused to withdraw their will contest. Boyd and Elizabeth filed a motion to enforce the MSA and to enter judgment in accordance with its terms.

The trial court held a hearing and ordered the parties to submit their disputes for binding arbitration in accordance with the terms of the MSA. On the day before the hearing, Jeanie Carr (a daughter of Talferd and Ella) appeared for the first time in the probate proceedings to question the validity of the 2012 Will and to object to the enforcement of the MSA, stating that she should be allowed to participate in the arbitration.

The trial court instructed Jeanie that she could file her own pleadings challenging the 2012 Will and the appointment of executors, and making any other claims regarding Ella's estate. But the trial court found that (1) her claims did not preclude other heirs from entering a settlement agreement and (2) because she was not a party to the MSA, she had no standing to participate in the arbitration proceeding.

The arbitrator signed an Arbitrator's Award, including as an exhibit the final form of the settlement documents contemplated by the MSA as determined by the arbitrator. Alice opposed confirmation of the Arbitration Award and entry of judgment in accordance with its terms, filing petitions to vacate or set aside the Award and the MSA. The trial court signed an order confirming the Award and ordering that it be enforced on its terms. Alice appealed.

On a no-evidence motion for partial summary judgment that Boyd and Elizabeth filed, the trial court sustained objections to certain evidence Jeanie offered and granted summary judgment against her. Jeanie non-suited the remainder of her claims and appealed. The Court of Appeals consolidated Jeanie's and Alice's appeals.

Law: Pursuant to the Texas General Arbitration Act, a trial court must confirm the award unless grounds are offered for vacating, modifying, or correcting the award under Section 171.088 or 171.091 of the Texas Civil Practice and Remedies Code. A party may avoid confirmation of the arbitrator's award "only by demonstrating a ground expressly listed" in the statute. Hoskins v. Hoskins, 497 S.W.3d 490, 494 (Tex. 2016). The common law allows a court to set aside an arbitration award only if the decision is a result of "fraud, misconduct, or gross mistake as would imply bad faith and failure to exercise honest judgment." Riha v. Smuleer, 843 S.W.2d 289, 292 (Tex. App. – Houston [14th Dist.] 1992, writ denied).

Holding: On appeal, the Court of Appeals of Texas affirmed the trial court's order confirming the Arbitration Award and ordering it enforced in accordance with its terms.

On appeal, Alice first asserted that the trial court erroneously excluded evidence showing that Alice was coerced into signing the MSA and excluded a medical report showing that Alice was incompetent, making her participation in the mediation and arbitration void. However, the hearing record demonstrated that Alice failed to preserve a claim that the trial court erred in excluding the evidence and that the medical report was excluded on grounds of hearsay. Thus, the Court of Appeals overruled each issue. Alice further asserted that the Arbitration Award was not "final, appropriate, and/or binding" because she had not signed the settlement documents. However, the Court of Appeals held that the Award is binding, final and effective once it is signed by the arbitrator – it is akin to a court order.

With respect to Jeanie's appeal, the Court of Appeals held that Jeanie failed to present the trial court with admissible evidence to raise a genuine issue of material fact regarding whether the 2012 Will was a forgery and whether the 2012 Will was executed as a result of undue influence. The Court of Appeals examined and overruled each of Jeanie's contentions on the admission of evidence and expert testimony, finding that Jeanie failed to provide any valid arguments supporting her contentions. The Court of Appeals affirmed the trial court's summary judgment order.

Practice Point: Practitioners should develop a clear understanding of the procedural nature of mediation and arbitration proceedings with respect to estate administration under applicable law. It is important that the practitioner as well as the client understand the binding and final nature of a mediation settlement and/or arbitration award, and the scope of application of such a settlement or award, especially before proceeding through mediation or arbitration.

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

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

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

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

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

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

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

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

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

Practice Point: A ruling that the SCA does not prevent providers from releasing content is certainly helpful to fiduciaries, however, we need to wait to see what happens on appeal to the United States Supreme Court, and how the issue of whether the disclosure is compelled is decided. In the meantime, it remains important to remind clients to keep a list of accounts and passwords with their important documents, and to utilize, to the extent possible, features designed to allow a successor to control an account, like Facebook's "Legacy Contact" designation.

67. <u>Higgerson v. Farthing</u>, 2017 WL 4224476 (Va. Cir. Ct. 2017)

> **A Trustee was held liable for breach of fiduciary duty and for excessive fees where the trustee was unnecessarily engaged in aggressive day trading and margin trading and his fees were not reasonable in relation to the work actually required to fulfill his fiduciary duties**

Facts: Upon the death of Ivan Higgerson, Philip Farthing became the trustee of a trust created for the benefit of Ivan's surviving spouse, Edith. Philip was an attorney, not a trained investor. As trustee, Philip engaged in extensive margin trading. At certain times, 100% of the stock account held by the trust was pledged to purchase additional stock on margin. Charles Schwab's algorithm identified Philip as a day trader.

In 2013, Philip made 2,500 trades during the calendar year, turning over the value of the portfolio approximately 55 times in that year, with little to no actual benefit. He did not disclose this information to Edith, nor did he inquire about other sources of income or assets available to Edith. Philip also did not disclose his method of calculating fees or his rate of pay. In one year he took $113,287.50 in fees, while, in the same year, cutting distributions to Edith from $80,000 to $0.

Overall, Philip took $1,057,000 in fees from the trust, which was equal to 38% of the total distributed to Edith. The trust agreement said the trustee should take "reasonable fees" but did not define the term. Philip claimed that his fees were based on a fee schedule used by his prior law firm. Edith and the remainder beneficiaries filed a complaint alleging that Philip breached his fiduciary duties and took excessive fees.

Law: In general, a trustee must administer a trust in the best interests of the beneficiary. In Virginia, and many other states, administering a trust in the best interests of the beneficiary requires a trustee to comply with the provisions of the Uniform Prudent Investor Act. The Uniform Prudent Investor Act provides that a trustee must invest and manage trust assets as a prudent investor would, "by considering the purposes, terms, distribution requirements and other circumstances of the trust." It also lists circumstances a Trustee should consider in applying that standard, including other resources of the beneficiary, needs for liquidity, and whether the trustee has special expertise. See Va. Code §§ 64.2-781 through 64.2-782.

The term "reasonable fees" is not defined in the Virginia Code, but the Supreme Court of Virginia has held that the determination of reasonable fees is based on the unique facts and circumstances of each case. See, e.g., Virginia Trust Co. v. Evans, 193 Va. 425, 433 (1952).

Holding: The Circuit Court of Virginia, First Judicial Circuit, Chesapeake City found that Philip's aggressive investment strategy involving day trading and trading on the margin was in violation of the prudent investor rule.

The Court acknowledged that in some cases, aggressive investment strategies like day trading and margin trading might be warranted and are not a per se breach of the prudent investor standard. For example, a trustee might reasonably borrow money on margin where it is necessary to provide funds to the beneficiary, where the trustee has considered other possible sources of funds for the beneficiary, or if the market has dropped precipitously and the trustee does not wish to sell stock to meet that need. However, the Court found in this case there was no reason for Philip to engage in this risky investment activity other than to generate his own fees, and he was "betting someone else's funds."

The Court determined losses for the breach of fiduciary duty by measuring the trust's total losses against the financial benchmarks presented by the expert witness of the beneficiaries. The Court imposed damages in the amount of $1,382,653.

Additionally, the Court found that Philip's fees were excessive and unreasonable. The Court did not find Philip's argument that his fees were based on a fee schedule published by his prior law firm persuasive, in part because the fees Philip charged after leaving the law firm were dramatically more than the amount charged when he was at the law firm. Looking to executor's fees as an example, the Court stated that 5% of the total trust value might be considered reasonable, depending on the level of work necessary.

In this case, the Court found that Philip was managing "plain vanilla trusts," so there was no reason for him to take the fees that he did, and that any additional work that would have justified the higher fees were a result of his own misbehavior in engaging in risky investment activity. The Court found that out of $1,057,000 Philip took in fees, only $286,722.15 were reasonable. The difference of $770,471.33 was awarded to the beneficiaries.

Practice Point: Although aggressive investment strategies may be warranted in some limited scenarios, a trustee should be mindful to comply with the prudent investor standard. Where a trust agreement does not define "reasonable fees", a trustee should be careful that the fees charged are actually reasonable in relation to the duties performed and should not assume that a published fee schedule is reasonable.

68. Bradley v. Shaffer, 535 S.W.3d 242 (Tex. App. 2017)

The transfer of a beneficial interest in trust property by a beneficiary was void because the trust contained a valid spendthrift provision, and the doctrine of after-acquired title is not applicable to a void transfer

Facts: Darell was the beneficiary of a fixed 1/8 interest in a trust. The trust held certain mineral interests in Taylor County, Texas. The trust was scheduled to terminate in June of 2013, but could be extended by the unanimous consent of all the beneficiaries. The trust contained a spendthrift provision that read, "[n]o Trustee nor beneficiary of this Trust shall have any right or power to anticipate, pledge, assign, sell, transfer, alienate or encumber his or her interest in the Trust in any way; nor shall any such interest in any manner be liable for or subject to the debts, liabilities, or obligations of such Trustee or beneficiary or claims of any sort against such Trustee or beneficiary."

Between March and June of 2013, the beneficiaries agreed to extend the trust. In 2006, before the trust was extended, Darell executed a mineral deed in favor of Terry Bradley. The mineral deed contained language referring to Darell's beneficial interest in the trust and conveying that interest, as well as any mineral interest held in the trust that he might acquire in the future to Terry.

Before June 2013, the Trustees and one of the other beneficiaries (Darell's sister, Darlene) filed a motion seeking a judgment declaring the deed from Darell to Terry invalid because (1) Darell did not have any title in the mineral interest to convey because the title was held by the trust and not by Darell; and (2) Darell had no authority to convey any beneficial interest in the mineral interest because of the trust's spendthrift provision.

Terry's response argued that (a) the trust was always invalid because the extension provision violated the rule against perpetuities and therefore Darell did have title to the minerals at the time of conveyance; and (b) even if the trust was invalid at the time of the conveyance, the extension of the trust was invalid under the rule against perpetuities and the trust therefore terminated in June 2013, at which point Darell's mineral interest passed to Terry pursuant to the doctrine of after-acquired title. Terry did not address the spendthrift trust provisions.

The trial court ruled in favor of the Trustees and entered a final judgement declaring Darell's deed to Terry void. Terry appealed.

Law: Spendthrift trusts prohibit a beneficiary from anticipating or assigning his interest in or income from the trust, and are permitted by the Texas Trust Code. See Tex Prop. Code § 112.035. The doctrine of after-acquired titled provides that if the seller conveys title to a property to a buyer, a subsequently acquired interest in that property by the seller is automatically passed through to the buyer. The doctrine of after-acquired title does not apply to void transfers.

Holding: On appeal, the Court of Appeals of Texas, Eastland, affirmed the lower court's judgment and found the conveyances to Terry void. The Court held that the initial trust was valid, and rejected the challenge to the trust based on the rule against perpetuities. Further, because the Trust contained spendthrift language, Darell's conveyance to Terry could not become effective even upon the eventual termination of the trust. The Court rejected Terry's argument that he should acquire legal title upon the termination of the trust based on the doctrine of after-acquired title, because the doctrine of after-acquired title does not apply to transfers that were void from the outset.

Practice Point: This case underscores the far-reaching effects of spendthrift protection of a beneficiary's interest. If a trust contains a spendthrift provision, a beneficiary cannot transfer his or her interest in the trust or to any of its underlying assets. Conversely, if a beneficiary attempts to or is forced by a creditor to convey an interest in a trust containing a valid spendthrift provision, the trustee can void the transfer. Third parties dealing with a beneficiary should be mindful of the potential limitations and restrictions imposed by a spendthrift clause.

69. Hodges v. Johnson, 2017 WL 6347941 (N.H. 2017)

The Supreme Court of New Hampshire affirmed an order declaring a trust decanting void ab initio and removed the trustees for breach of duty of impartiality

Facts: David Hodges created two irrevocable trusts to hold stock in a family business, with his attorney, William Saturley, and Alan Johnson, an employee of the family business, as trustees. The trusts' beneficiaries were Hodges' wife, Joanne, his three children, and his two step-children.

The trusts provided for discretionary distributions to each of the beneficiaries during Hodges' lifetime. After his death, Joanne was named the primary beneficiary. Following Joanne's death, the trustee was to divide the trust into five separate trusts for each of Hodges' children and step-children. The trustee of each separate trust had discretionary power to distribute the net income and principal to the child and his or her descendants.

The trusts also included provisions specifically related to the family business. Each trust instrument established a "committee of business advisors", chosen by Hodges, with exclusive authority to make decisions for the family business after Hodges' death. Hodges funded the trusts with non-voting stock in various entities.

In 2009, Hodges retained attorney Joseph McDonald to assist with his estate planning. Hodges stated he wished to revoke the gifts to his step-children. McDonald advised Hodges that, although the trusts were irrevocable, the trustees could decant to new trusts, of which the step-children would not be beneficiaries. McDonald also offered to serve as the trustee who would accomplish the decanting.

Over the next few years, McDonald decanted the trust three times. First, in 2010, Johnson resigned as trustee in favor of McDonald. McDonald decanted both trusts, reappointed Johnson as trustee, and resigned. The decanted trusts specifically excluded Hodges' step-children as beneficiaries of the trusts.

Second, in 2012, McDonald was appointed as trustee and decanted the trusts to exclude Hodges' biological son, David Hodges Jr. Again, to accomplish this, Johnson resigned as trustee in favor of McDonald, and McDonald decanted the trusts to new trusts that excluded Hodges Jr. and the step-children. McDonald then resigned in favor of Johnson.

Third, and lastly, in 2013, McDonald was appointed as trustee and decanted the trusts for a third time in order to exclude Joanne. Once again, after the decanting, McDonald resigned in favor of Johnson.

In April 2014, Hodges Jr. and the step-children filed a petition to invalidate the decantings and to remove Johnson and Saturley as trustees, alleging a breach of the duty of impartiality. McDonald admitted he did not consider the excluded beneficiaries' interests when he decanted the trusts, but he maintained that he was not required to do so.

The trial court agreed the trustees had breached the duty of impartiality. Therefore, it declared the decantings void ab initio and removed Johnson and Saturley as trustees. Johnson, Saturley, and McDonald appealed.

Law: The duty of impartiality does not require a trustee to treat beneficiaries equally. For example, a trustee may make unequal distributions among beneficiaries, or eliminate a beneficiary's non-vested interest through decanting, if the trustee treats the beneficiaries equitably in light of the trust's terms and purposes. However, a trustee may not abuse its discretion in favoring certain beneficiaries over others.

Analysis: The Supreme Court of New Hampshire affirmed the trial court's order declaring the decanting void ab initio and removing Saturley and Johnson as trustees. The Court noted McDonald's admission that he did not consider the excluded beneficiaries' interests when he decanted the trusts. The Court found that supporting the five named beneficiaries was a primary purpose of the trust. Therefore, McDonald abused his discretion by eliminating the beneficiaries without considering their interests or other alternatives to promote the effective administration of the trusts.

The Court also rejected the trustees' argument that the decantings were necessary to protect the family business from intra-family conflict. The Court noted that the committee of business advisors had sole authority to manage the business, and that Hodges had the power to remove and replace committee members. The Court also observed that the trusts held only non-voting stock in the business. Therefore, the Court found that the beneficiaries' interests in the trusts did not threaten the family business.

Finally, the Court affirmed the trial court's removal of Johnson and Saturley as trustees. The Court noted its power to remove a trustee who has committed a serious breach of trust. The Court held that the trial court could have reasonably concluded that McDonald's decantings were a serious breach of trust.

Practice Point: State law generally does not require trustees to treat beneficiaries equally. However, a trustee must always act in good faith in accordance with the trust's terms and purposes, and must treat the beneficiaries equitably, based on the terms of the trust. A trustee should consider all purposes of a trust, including the interests of the beneficiaries, before making key decisions involving a trust, such as decanting. Moreover, the trustee should document that he, she or it considered those factors.

70. Matter of Sinzheimer, 2017 N.Y. Slip Op. 31379(U) (Surr. Ct. New York Cnty.)

Corporate trustee removed under the terms of the trust was not required to deliver the trust assets to individual co-trustee when a successor corporate trustee had not been appointed

Facts: Ronald and Marsha Sinzheimer created an irrevocable trust under agreement dated as of January 27, 1997. The trust terms provided for discretionary income and principal payments to Marsha for her lifetime, then directed the remaining trust assets to another trust under the trust agreement.

The trust agreement provided for the removal and appointment of successor trustees. The trust agreement stated that, before Ronald's death, the trustee "may" appoint a bank or trust company as co-trustee of the trust. Upon Ronald's death, however, the trust agreement stated that the individual trustee "shall" appoint a bank or trust company as co-trustee. Furthermore, the trust agreement stated that, if the individual trustee removes a corporate trustee after Ronald's death, the individual trustee "shall" appoint a successor corporate trustee.

Ronald died in 1998. After Ronald's death, the individual trustee appointed Merrill Lynch Trust Company ("Merrill Lynch") as corporate co-trustee. The individual trustee later removed Merrill Lynch as corporate co-trustee and resigned his own trusteeship in favor of Ronald and Marsha's son, Andrew. The individual trustee did not appoint a successor corporate co-trustee.

After Andrew accepted fiduciary duties, he and Marsha requested that Merrill Lynch distribute all of the trust assets to Marsha outright. Merrill Lynch asked for Marsha's tax returns and budgets in order to evaluate the request. Marsha refused. Instead, Andrew asserted that he was not required to appoint a successor corporate co-trustee, and demanded that Merrill Lynch deliver the trust assets to him as sole trustee of the trust. Andrew also announced that he intended to exercise his discretion as trustee to distribute the trust assets to Marsha outright. Merrill Lynch refused to transfer the trust assets to Andrew.

Andrew and Marsha filed a petition in the New York Surrogate's Court to remove Merrill Lynch as corporate co-trustee and compel it to transfer the trust assets to Andrew as sole trustee of the trust. Alternatively, they sought damages equal to the trust assets. Andrew and Marsha also argued Merrill Lynch committed civil conversion of the trust assets and sought $400,000 in punitive damages.

In response, Merrill Lynch petitioned the Court for an order directing Andrew to appoint a successor corporate co-trustee or alternatively authorizing Merrill Lynch to transfer the trust assets to Andrew as sole trustee.

Law: A court will give full force and effect to the plain language of a trust unless the terms are ambiguous. A custodian of property may retain the property until the owner proves his or her right to the property.

Analysis: The Surrogate's Court for New York County held that the trust terms clearly required Andrew to appoint a successor corporate co-trustee. Analyzing the trust terms, the Court observed that, before Ronald's death, the individual trustee "may" appoint a corporate fiduciary, but the trust terms stated that a corporate fiduciary "shall" be appointed upon Ronald's death. The Court also noted that, if the individual trustee removed a corporate co-trustee, the individual trustee "shall" appoint a successor co-trustee. Therefore, the Court denied Andrew and Marsha's petition.

The Court also rejected Andrew and Marsha's claim for conversion and punitive damages. Merrill Lynch did not assert title to the trust assets. Instead, it only requested that Andrew demonstrate his right to the property. Andrew could not demonstrate that right, because the trust terms did not allow him to serve as sole trustee. The Court also found Merrill Lynch's petition, filed four months after Andrew refused to appoint a successor corporate co-trustee, was filed expeditiously.

Practice Point: A removed trustee is generally required to transfer expeditiously the trust assets to the successor trustee. However, a removed trustee may retain fiduciary duties under the trust terms until a successor trustee is appointed. When the remaining trustee refuses to comply with the trust terms, or intends to take an action that may violate the terms of the trust, it may be prudent for the removed trustee to petition for court instruction before acceding to the remaining trustee's demands. The petition should be filed expeditiously and explain how the proposed action would violate the trust terms.

In communications with co-trustees and beneficiaries, though, the removed trustee should be careful not to assert title to the trust property. Instead, the trustee should make clear it is retaining custody only until the successor trustee proves its right to the property.

71. IMO Ronald J. Mount 2012 Irrevocable Dynasty Trust U/A/D December 5, 2012, No. CV 12892-VCS, 2017 WL 4082886 (Del. Ch. Sept. 7, 2017)

Delaware Chancery Court holds that a trust instrument may allow a trust protector to act in a non-fiduciary capacity. Therefore, it dismissed a claim against a trust protector for breach of fiduciary duties

Facts: Ronald J. Mount created the Ronald J. Mount 2012 Irrevocable Dynasty Trust under agreement dated as of December 5, 2012. Ronald named his long-time attorney, Kevin Kilcullen, as trust protector of the dynasty trust, and provided that he was to act in a non-fiduciary capacity. After Ronald died in 2015, his wife, Rene, and two children, Heather and Ian, initiated several lawsuits in multiple jurisdictions over the distribution of Ronald's estate

On July 5, 2016, Rene, Heather, Ian, and Kevin (and others) entered into a global settlement agreement to resolve the various lawsuits. The settlement agreement purportedly resolved how the dynasty trust and Ronald's revocable trust would be funded and administered. First, the dynasty trust would be divided into two separate trusts, one trust for Heather, and one trust for Ian. Heather's trust would be funded with $10 million, less one-half of certain expenses and taxes, and the remaining dynasty trust assets would fund Ian's trust.

After the relevant courts approved the settlement agreement, Heather, Ian, and Kevin began to disagree over the trusts' liabilities. Kevin, as trust protector of the dynasty trust, argued that Ian was required to pay a $4.2 million debt owed by the revocable trust to the dynasty trust.

Ian acknowledged that the $4.2 million debt to the dynasty trust was valid. However, he claimed that the debt was offset by a $6.9 million debt the dynasty trust owed to the revocable trust. Therefore, Ian argued the debts should partially offset, and in fact, the dynasty trust owed $1.4 million to the revocable trust.

When negotiations failed, Kevin filed a petition for instruction in the Delaware Court of Chancery. Ian filed counterclaims against Heather and Kevin alleging that Kevin had breached his fiduciary duties, notwithstanding the terms of the trust. Heather and Kevin filed separate motions to dismiss Ian's counterclaims.

Law: Under Delaware law, a grantor may allow an advisor, including a trust protector, to serve in a non-fiduciary capacity.

Analysis: The Delaware Court of Chancery dismissed Ian's breach of fiduciary duty claim against Kevin. The Court cited the terms of the dynasty trust, which stated that the trust protector did not act in a fiduciary capacity. The Delaware Code expressly allows grantors to provide that a trust protector serve in a non-fiduciary capacity.

The Court also rejected Ian's argument that the trust protector was a fiduciary despite the terms of the dynasty trust. Ian first argued that Kevin acted in a fiduciary capacity because Kevin also served on the trust's investment committee, through which he owed fiduciary duties. The Court noted that none of Kevin's alleged breaches arose in his capacity as an investment committee member. Therefore, the Court rejected Ian's argument.

Ian also argued that Kevin's expansive powers as trust protector imputed fiduciary duties upon him. Again, the Court rejected Ian's argument. Ian did not cite any statutes or case law to support his position; instead, he relied on law review articles questioning statutes that allow trust protectors to serve in a non-fiduciary capacity. In light of the clear terms of the trust and the statute, the Court rejected this argument as well.

Practice Point: State law may allow grantors to decide whether a trust protector will serve in a fiduciary or non-fiduciary capacity. In those jurisdictions, when the terms of the trust are clear, courts will give effect to trust terms even if the trust protector possesses expansive powers. Advisors should discuss with clients the benefits and drawbacks of allowing an advisor to serve with or without fiduciary duties in light of the client's goals.

72. <u>Laborers' Pension Fund v. Miscevic</u>, No. 17-2022 (7th Cir. Jan. 29, 2018)

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

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

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

Holding: On appeal, the Court of Appeals for the Seventh Circuit upheld the interpretation that a slayer is precluded from obtaining the benefits payable under the decedent's pension plan even if they were found not guilty by reason of insanity. The Court reasoned that slayer statutes are traditionally an area of state regulation, and it rejected Anka's argument that Congress intended to preempt the slayer statutes through ERISA.ERISA was enacted after it was well established that an individual who kills another individual cannot benefit as a result of that death. Therefore, Congress could have clearly stated that it intended to change that result in certain situations, but their failure to explicitly state that intent results in a determination that it was not their intent.

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

Practice Point: It is important to remember that federal statutes or regulations may be affected by state statutes. Lawyers should be mindful of other statutes that may change the outcome in particular situations.

73. <u>Metropolitan Life Ins., Co. v. Teixeira</u>, Civ. No. 16.07486 (D.N.J. 2017)

Interpleader protection does not extend to counterclaims that are not claims to the interpleaded funds

Facts: John J. Teixeira owned a life insurance policy on himself. The policy provided that the beneficiary may be any person the owner chose, but changes must be made in writing on a form approved by the insurance company and filed with the insurance provider. Teixeira's initial beneficiary designation named his wife, Janet Teixeira, as the sole beneficiary. This designation was made by telephone in March 2003. In July of 2015, Teixeira called MetLife to change his beneficiary designation to Gabriela Ramirez.

John Teixeira died in April of 2016.His daughter, Karen Sarto, claimed the benefits from the policy on Janet Teixeira's behalf. Along with her claim, she submitted a death certificate and a copy of the order stating she is the guardian of her mother, and therefore is allowed to act on her behalf. Sarto learned of the attempted beneficiary change and asserted John was incompetent at the time of the purported change. In June 2016, Ramirez also submitted a claim for the proceeds of the policy.

MetLife attempted to assist the parties in settling their dispute, but that attempt was unsuccessful. MetLife then filed an action for interpleader, alleging that it cannot determine whether the decedent was competent at the time of the beneficiary change. MetLife was granted interpleader relief. However, the Court refused to relieve MetLife from any and all liability relating to the claims. MetLife appealed.

Law: An interpleader action cannot be used to dismiss an insurance provider from liability for claims that are not related to the interpleaded funds.

Holding: Interpleader is equitable relief that allows a party that holds property more than one person claims they are entitled to join those two competing claims in one action. It allows a party who admits they are liable to one party, but fears liability to multiple parties to submit the property or money at issue to the Court and withdraw from the proceedings while the claimants litigate their claims.

The Court held that MetLife was entitled to some protection because it cannot determine which claim is superior without opening itself to double liability. The determination of who is entitled to the insurance proceeds depends on capacity of the decedent, and MetLife is not in the position to make that determination.

The Court further held that here, however, there was a possibility for an independent counterclaim based on the negligence of MetLife in allowing the oral beneficiary change when the policy states that a beneficiary change must be submitted in writing on an approved form. Therefore, there was a potential claim that is outside the scope of interpleader, and the Court concluded that MetLife cannot use impleader to relieve itself of liability for counterclaims that are not claims to the interpleaded funds.

Practice Point: Custodians or third parties can often find themselves in the middle of a dispute regarding the proper recipients of funds upon a person's death or similar situations. In such a case, interpleader can offer protection to that third party. However, interpleader actions that are granted do not protect parties like the insurance company from all liability, but rather they are only protected from liability as it relates to the interpleaded funds.

74. Harvey ex rel. Gladden v. Cumberland Tr. & Inv. Co., 532 S.W.3d 243 (Tenn. 2017)

Trustee had authority to enter into predispute arbitration agreement with financial advisor, and outcome of arbitration bound beneficiaries

Facts: Alexis Breanne Gladden was the minor beneficiary of a trust ("Alexis' Trust") created in 2001 and initially funded with $2,600,000. Alexis had suffered severe injuries after a stay in the hospital as an infant, and the proceeds of medical malpractice settlements constituted the entirety of her trust's corpus.

Cumberland Trust and Investment Company ("Cumberland") became sole trustee of Alexis' Trust in 2004. Five years later, Cumberland executed an account service agreement (the "Account Agreement") with Wonderlich Securities, Inc. ("Wonderlich") and Wonderlich-employee Albert M. Alexander, Jr. ("Alexander"), each of whom had provided investment management services to the trust for a number of years. The Account Agreement, which contained a predispute arbitration clause, was signed by Alexander, Cumberland, and Wonderlich, but not by Alexis or her representatives.

In 2011, Alexis' maternal grandfather, Wade Harvey, Sr. ("Harvey") succeeded Alexis' mother as Alexis' guardian. Shortly after his appointment, Harvey realized that the value of Alexis' Trust had fallen to less than $200,000.He then brought suit against Cumberland, Wonderlich, and Alexander for breach of fiduciary and contractual duties. The defendants moved to compel arbitration of those claims, and the trial court granted that motion to compel arbitration.

The Supreme Court of Tennessee agreed to review an interlocutory appeal of the trial court's order compelling arbitration of Harvey's claims. The Court of Appeals reversed. The defendants appealed.

Law: The Tennessee Uniform Trust Code (the "TUTC") gives trustees broad authority to select the commercial means by which they fulfill their fiduciary duties. Specifically, the TUTC permits trustees to enter into predispute arbitration agreements, so long as such agreements are not explicitly prohibited by the terms of the relevant trust instrument.

Holding: On appeal, the Supreme Court sided with the trial court, and compelled arbitration of Harvey's claims.

Alexis' trust instrument did not specifically prohibit Cumberland from entering into predispute arbitration agreements. As a result, Cumberland was impliedly authorized by the TUTC and the trust instrument to enter into such agreements. Further, Alexis was bound by the provisions of the Account Agreement insofar as she was a third-party beneficiary seeking to enforce rights under its terms.

The Court returned the case to the trial court for a determination of which of Harvey's claims sought to enforce the terms of the Account Agreement and were thus subject to its predispute arbitration provisions.

Practice Point: Under the laws of Tennessee, and now, perhaps, of other Uniform Trust Code jurisdictions, corporate fiduciaries have broad authority to enter into predispute arbitration agreements absent specific language prohibiting such contracts in the relevant trust instrument. Additionally, predispute arbitration provisions might bind not only a given contract's signatories, but also trust beneficiaries who seek to enforce duties created by the contract. Despite the potentially broad reach of this Court's reasoning, the Harvey decision is narrow in at least one important way. In footnote 34 of the Court's decision, the Court left open the possibility that factual situations could arise in which entering into a predispute arbitration agreement could violate a trustee's fiduciary duties. Arbitration clauses are, therefore, neither automatically prohibited nor necessarily permitted. Nevertheless, this case continues courts' enforcement of arbitration clauses in the context of claims for breach of fiduciary duty.

OTHER ITEMS OF INTEREST

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

Broker not liable for annuity beneficiaries taking lump sum distributions

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

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

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

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

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

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

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

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

76. <u>Estate of Rubin A. Meyers v. Commissioner</u>, T.C. Memo 2017-11

Recipients of assets received by means other than a will or state law governing the distribution of a deceased person's property could be liable for unpaid estate taxes ten years later

Rubin A. Meyers died in November 2005. On February 15, 2007, the executor filed a federal estate tax return and began making installment payments pursuant to Section 6166. In 2007 through 2013, the estate made the required payments. In 2014, the estate became delinquent. A revenue officer was assigned to collect the delinquent payments. On October 7, 2014, the revenue officer filed the Notes of the Federal Tax Lien ("NFTL") and shortly thereafter notified the executor that the NFTL had been filed and of this right to a Collection Due Process ("CDP") hearing. On October 29, 2014, the revenue officer notified the executor of the IRS's intent to levy to collect the delinquent tax and of his right to a CDP hearing. The unpaid liability for estate tax, interest, and penalties was then $380,000. The estate timely submitted a request for a CDP hearing, asking for an offer in compromise and stating that he was unable to pay the balance due and requesting withdrawal of the NFTL.

After the submission of the request form, the revenue officer made an inappropriate contact with the settlement officer assigned to conduct the CDP hearing. As a result, the case was assigned to another settlement officer. A face to face meeting was set for April 9, 2015. Prior to the hearing, the executor provided the settlement officer with the financial information but did not submit a completed offer in compromise.

At the hearing, the executor stated that paying the delinquent estate tax liability from probate assets would require the sale of family farm lands that would be difficult to liquidate. He suggested that the IRS take action to collect the delinquent liability from third parties that had received cash or liquid non-probate assets. He also represented that he had no access to non-probate assets as a source of funds to pay the estate tax liability. As a result of the hearing, the settlement officer determined that the estate did not qualify for non-collectible status or hardship, but that the IRS could pursue collection of the estate tax from non-probate assets. The NFTL was kept in place because the petitioner had not provided sufficient justification for withdrawal.

The special estate tax lien against the family farm expired on November 15, 2015, ten years after decedent's death. The IRS had not taken any action to attach or otherwise collect the estate tax liability with respect to the non-probate assets. The court held that while the ten year period for imposing personal liability could still be open after expiration of the ten year special estate tax lien against the family farm and the probate estate. Although the lien begins to run as of the date of death, the ten year collection period runs from the date of assessment.

77. <u>Estate of Marion Levine v. Commissioner</u>, Docket No. 13370-13 (Tax Court October 26, 2017)

Estate granted protective order limiting scope of IRS subpoena

In a case scheduled for trial in November 2017, the estate moved for a protective order on October 18, 2017 to limit the scope of a subpoena duces tecum that the IRS served in September on Shane N. Swanson and his firm Stinson Leonard Street, LLP, which was one of the firms representing the estate. It asked for all documents that Swanson and Stinson Leonard had in their files for the decedent and her estate for the period from January 1, 2007 until July 1, 2017. The representatives of the estate and trustees of Levine's trust stated that anything after April 19, 2013, which was the date that the IRS issued the notice of deficiency, was work product, and it would be unduly burdensome to prepare a privilege log so close to trial for what would inevitably prove undiscoverable material.

Swanson was a key player in the case. He created Marion Levine's estate planning and prepared the estate tax return at issue. Swanson filed the estate tax return in April 2010 and he responded on behalf of the estate during the audit that lead to the notice of deficiency in April 2013. The IRS now sought to look at the files all the way through the middle of 2017. The court first noted that the work product privilege exists to prevent "unwarranted inquiries into the files and the mental impressions of an attorney" because "it is essential that a lawyer work with a certain degree of privacy." The privilege specifically limits the discovery of documents prepared "in anticipation of litigation." Courts previously held that documents prepared during audit and before the IRS issues a notice of deficiency can be created "in anticipation of litigation", Bernardo v. Commissioner, 104 T.C. 677 (1995). Any documents that Swanson and his firm produced after the estate retained him specifically for the litigation likely fit within the definition of work product. Previously, the Tax Court had held that raising a good faith defense could waive the attorney-client privilege, but the IRS cited no authority saying that raising the defense waives the doctrine with respect to documents produced after the litigation begins. The court consequently limited the subpoena to the period beginning January 1, 2007 and ending April 19, 2013 which was prior to the issuance of the notice of deficiency.

78. Hawk, Billy F., Jr. GST Non-Exempt Marital Trust, et al. v. Commissioner, T.C. Memo 2017-217

Decedent's estate, two marital trusts, and decedent's widow were liable as transferees under Section 6901 and applicable state law for unpaid income taxes from the sale of a bowling alley

Billy F. Hawk, Jr. died in February 2000. At the time of his death, Mr. Hawk owned and managed two bowling alleys in Tennessee through Holiday Bowl, Inc. ("Holiday Bowl"). At the time of the transactions at issue in this case, the estate owned 81.25% of Holiday Bowl, including 100% of the voting stock. Mrs. Hawk owned the remaining 18.75%.

The IRS asserted that transferee liability for income taxes arose from a series of transactions in 2003 involving Holiday Bowl that occurred after Mr. Hawk's death. First, Holiday Bowl sold its primary assets, the two bowling alleys, to an unrelated third party. Next, Holiday Bowl distributed unimproved real property to the estate and Mrs. Hawk in a stock redemption. The same day as the redemption, the estate and Mrs. Hawk sold the remaining shares to an unrelated third party, MidCoast Investment Inc. ("Midcoast") and its related entities, which as the court put it, was a "familiar entity in recent transferee liability cases." MidCoast immediately resold the stock to yet another third party. The estate subsequently distributed the proceeds from the MidCoast transaction to the two marital trusts. The petitioner saved approximately $300,000 in tax by engaging in the MidCoast transaction. The tax savings represented an approximate 15% premium above Holiday Bowl's book value. The IRS sought to recover approximately $1.3 million in taxes and a penalty from petitioners.

The basic strategy in which MidCoast engaged was to leverage its profits by purchasing Holiday Bowl's cash at a discount based on its tax liability and then deferring the actual payment of tax since MidCoast had heavy expenses in the early months after a loan portfolio purchase. MidCoast has more cash available to purchase loans so it ends up making a greater profit in the end.

For transferee liability to be imposed under Section 6901(a) a court must determine whether:

1. The transferor is liable for the unpaid tax;

2. The petitioners are liable as transferees within the meaning of Section 6901; and

3. Petitioners are subject to substantive liability as transferees under applicable state law or state equity principles.

The court found that the petitioners should have known that MidCoast did not have a legitimate strategy to avoid or defer Holiday Bowl's 2003 income tax. Petitioners and their advisors knew that the IRS had identified intermediary transactions similar to the MidCoast transactions as listed transactions that the IRS considered abusive tax shelters and should have known that the IRS would scrutinize the MidCoast transaction, on that basis. This was discussed in Notice 2001-16, 2001-1 C.B. 730. In addition, the taxpayers did not obtain a tax opinion that analyzed the IRS's pronouncement in Notice 2001-16 on listed transactions. The court also noted that the petitioners knew that Holiday Bowl would not pay tax for 2003 and there is no distinction between the nonpayment of the income tax in 2003 and the advisor's characterization of MidCoast's stated tax strategy as a deferral of tax, as petitioners knew there was a likelihood that Holiday Bowl would be insolvent after 2003 and would exist as a shell.

The court then noted that for purposes of Section 6901, the term "transferee" includes a donee, heir, devisee, distributee, or shareholder of the dissolved corporation. The court held that the petitioners faced joint and several liability under Section 6901. It then held that the estate and nonexempt trust were liable for the accuracy related penalty asserted against Holiday Bowl. Finally, the court held that the nonexempt trust and the estate were liable for pre-notice interest. Because Mrs. Hawk and the exempt trust did not control the filing of the tax return, the tax payment, or the tax documentation, they were not held liable for pre notice interest.

79. United States v. Raelinn M. Spiekhout (In the Matter of Estate of Simmons), ___ F. Supp. 3d ___ (S.D. Ind. July 31, 2017)

Government's tax liens have priority

Frederick Allen Simmons died on June 5, 2014. Raelinn M. Spiekhout, the decedent's second wife, was the surviving spouse and personal representative of the estate. The principal asset of the estate was a residence in Zionsville, Indiana. Simmons's first wife was Deborah Scott. Simmons and Scott had one child, Erik Simmons, who was born in 1991. When Scott and Simmons divorced in 1998, the divorce decree provided in relevant part that Simmons would pay $1,274 per month in child support, $1,000 per month in maintenance, Erik's health insurance benefits, and any of Erik's uninsured healthcare costs. Simmons also agreed to hold Scott harmless from any and all encumbrances on the property and quitclaim. Scott qui claimed her interest in the property to Simmons.

Upon opening of the estate, a number of claims were filed, including claims by Scott for past due child support, alimony, medical expenses, insurance expenses, claims for unpaid wages and benefits, a claim for an alleged breach of lease, a claim for default of a promissory note, a claim by the State of Indiana for two tax warrants, and a claim by the Internal Revenue Service for unpaid federal income taxes totaling $591,406.

On March 16, 2015, Spiekhout filed a petition to approve the sale of the property for $282,000 but did not file a notice to trigger the 30-day removal period. The state court approved the sale on April 16, 2015. Spiekhout filed a petition to close the estate as insolvent showing that the estate anticipated having total distributable assets of only $266,872.70 as contrasted against $1,812,621.69 in claims.

On July 10, 2015, the state court issued an order closing the estate as insolvent. The distribution listed the federal tax lien as seventh in priority amount creditors. On July 14, 2015, the government moved the state court action to federal court, challenging the state court's disposition of the tax lien. Spiekhout then argued that the government's federal tax lien does not have priority over Spiekhout's claim for preserving the property, because compensation for services provided the estate are debts of the estate, rather than debts of the debtor. The government argued that it properly filed notice of its federal tax liens and those liens should prevail over Spiekhout's interests because Spiekhout was not a secured creditor. As a result, the court specifically concluded that the federal tax lien had priority regarding the proceeds of the estate.

80. Letter Ruling 201750004 (Issued September 12, 2017; Released December 15, 2017)

Subtrust is valid see-through trust

Decedent established a revocable living trust. Decedent died at age 61. Upon Decedent's death, the revocable trust became an irrevocable trust with Daughter as the sole beneficiary of the trust. A subtrust was established to hold all of the assets from Decedent's retirement accounts. Daughter was the sole beneficiary of the subtrust. At the time of her death, Decedent held one traditional individual retirement account, one Roth individual retirement account, and two annuity contracts under her former employer's Section 403(b) plan.

The taxpayer requested a ruling that the applicable distribution period for the retirement accounts held by Decedent was to be calculated based on the life expectancy of Daughter, the designated beneficiary of the subtrust. The Service noted that because the retirement accounts each listed the subtrust as the beneficiary, it must determine whether the requirements of a see-through trust had been met. The documentation provided showed that the trust was valid and irrevocable. The third requirement is that the beneficiary or beneficiaries be identifiable within the trust document. The Service found that the Daughter was identifiable in the subtrust and was the sole designated beneficiary of the retirement accounts.

The determination of whether the subtrust qualified as a see-through trust depended on whether the beneficiaries of the subtrust could be identified at the time of Decedent's death. The trust provided Daughter with a testamentary general power of appointment. This power of appointment generally applies to any accumulation of retirement account distributions that would accumulate in the subtrust. However, when the subtrust was read together with the trust, the subtrust required the trustee to pay to Daughter any and all funds in the subtrust that were drawn by the trustee including the minimum distributions during Daughter's lifetime. Consequently, there could be no accumulation of retirement account distributions in the subtrust for the benefit of any other beneficiary. As a result, all of the beneficiaries were identifiable and the required minimum distributions could be paid based on the life expectancy of Daughter as the sole designated beneficiary of the subtrust.

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

IRS grants extension to waive family attribution rules

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

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

1. Immediately after the distribution, the distributee had no interest in the corporation other than as a creditor;
2. The distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within ten years from the date of such distribution; and
3. The distributee at such time and in such manner and the distributee notifies the secretary.

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

82. <u>United States v. Paulson</u> __ F. Supp. 3d __ (S.D. Cal. 2018)

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

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

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

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

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

On January 16, 2005, the IRS issued a notice of deficiency to Michael as executor of the estate which proposed a $37,801,245 deficiency in estate tax. This was argued before the tax court and the tax court determined that the estate had $6,669,477 in additional estate tax which the estate elected to pay under Section 6166. During 2006, Michael distributed an additional $1,250,000 from the living trust. In March 2009, the probate court removed Michael Paulson as trustee for misconduct. At that point, two other children of Allen, Vikki Paulson and James Paulson were appointed as co-trustees. They reported that the living trust had assets worth $13,738,727. On May 7, 2010, in response to one or more missed installment payments, the IRS issued the estate a notice of final termination, stating that the extension of time for payment under Section 6166 no longer applied. On June 10, 2010, the probate court removed James Paulson as a co-trustee for breach of court orders. Accordingly, Vikki remained as the sole trustee of the living trust.

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

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

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

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

1. the possible damage which may result in granting the stay;
2. the hardship or inequity which a party may suffer in being required to go forward; and
3. the orderly course of justice measured in terms of the simplifying or complicating of issues, proof, and questions of law which could be expected result from a stay.

The court in looking at the request determined that the defendants would not suffer undue hardship if the action was not stayed. It then noted, that the government would be prejudiced if a stay were granted. It noted the defendants made this request nearly three years after the government first filed this action and provided no indication of when the probate court would resolve the issues. In addition, the probate petition would not simplify the issues before the court. Instead, because this case invoked the federal question, as well as issues that the federal court had been dealing with since 2015, staying the case would be "unconstructive". As a result, all three factors weighed against the defendants' motion to stay and the motion was denied.

83. Changes in state death taxes in 2018

Several states see changes in their state death taxes in 2018

Several states either made changes or saw changes in their state death taxes as a result of the doubling of the federal estate tax applicable exclusion amount under the 2017 Tax Act. In Hawaii, on June 7, 2018, the governor signed SB 2821, which amended HI ST § 236E-6 to reduce the Hawaiian exemption, effective January 1, 2018, to $5,000,000 indexed for inflation.

Maine does not appear to have picked up the amendments made in the 2017 federal tax reform act. For estates of decedents dying on or after January 1, 2016, the "Maine exclusion amount "means the basic exclusion amount determined for the calendar year in accordance with Section 2010(c)(3) of the "Code." 36 M.R.S. § 4102(5). However, Maine's tax law defines "Code" as the United States Internal Revenue Code of 1986 and any amendments to that Code as of December 31, 2016. This arguably means that the Maine exemption equals the exemption prior to the changes made by the 2017 Tax Act.

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

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

The District of Columbia has decoupled its exemption from the federal exemption. DC Bill B22-0685 was introduced in the DC City Council on February 8, 2018 and was enacted on September 5, 2018. This law cuts the DC threshold to $5.6 million retroactive to January 1, 2018. The threshold will be indexed for inflation. It is subject to 30 days Congressional review.

Other states saw changes unrelated to the 2017 Tax Act. In Connecticut, on October 31, 2017, the Connecticut Governor signed the 2018-2019 budget which increased the exemption for the Connecticut state estate and gift tax to $2,600,000 in 2018, to $3,600,000 in 2019, and to the amount of the federal estate and gift tax exemption in 2020. Beginning in 2019, the cap on the

Connecticut state estate and gift tax is reduced from $20 million to $15 million (which represents the tax due on a Connecticut estate of approximately $129 million).

Delaware in 2017 repealed its state death tax effective January 1, 2018.

84. 2018 State Death Tax Chart (as of September 17, 2018)

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
Alabama	None	Tax is tied to federal state death tax credit. AL ST § 40-15-2.		
Alaska	None	Tax is tied to federal state death tax credit. AK ST § 43.31.011.		
Arizona	None	Tax was tied to federal state death tax credit. AZ ST §§ 42-4051; 42-4001(2), (12). On May 8, 2006, Governor Napolitano signed SB 1170 which permanently repealed Arizona's state estate tax.		
Arkansas	None	Tax is tied to federal state death tax credit. AR ST § 26-59-103; 26-59-106; 26-59-109, as amended March, 2003.		
California	None	Tax is tied to federal state death tax credit. CA REV & TAX §§ 13302; 13411.		
Colorado	None	Tax is tied to federal state death tax credit. CO ST §§ 39-23.5-103; 39-23.5-102.		
Connecticut	Separate Estate Tax	As part of the two year budget which became law on September 8, 2009, the exemption for the separate estate and gift taxes was increased to $3.5 million, effective	On October 31, 2017, the Connecticut Governor signed the 2018-2019 budget which	$2,600,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		January 1, 2010, the tax rates were reduced to a spread of 7.2% to 12%, and effective for decedents dying on or after January 1, 2010, the Connecticut tax is due six months after the date of death. CT ST § 12-391. In May 2011, the threshold was lowered to $2 million retroactive to January 1, 2011.	increased the exemption for the Connecticut state estate and gift tax to $2,600,000 in 2018, to $3,600,000 in 2019, and to the federal estate and gift tax exemption in 2020. On May 31, 2018, Connecticut changed its estate tax law to extend the phase-in of the exemption to 2023 to reflect the increase in the federal exemption to $10 million indexed for inflation in the 2017 Tax Act. The exemption will be phased in as follows: 2019: $3.6 million 2020: $5.1 million 2021: $7.1 million	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
			2022: $9.1 million: 2023: federal exemption for deaths on or after January 1, 2023. Beginning in 2019, the cap on the Connecticut state estate and gift tax is reduced from $20 million to $15 million (which represents the tax due on a Connecticut estate of approximately $129 million).	
Delaware	None	On July 2, 2017, the Governor signed HB 16 which sunsets the Delaware Estate Tax on December 31, 2017.		
District of Columbia	Pick-up Only	As a result of 2015 legislation as modified in 2017, the threshold will match federal exemption as it is indexed for inflation beginning in 2018. DC CODE 47-3701(14)	DC Bill B22-0685 was introduced in the DC City Council on February 8, 2018. This proposal cut the DC	$5,600,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		No separate state QTIP election.	threshold to $5.6 million retroactive to January 1, 2018. This change was enacted by the DC City Council on September 5, 2018 as part of the Budget Support Act. It is subject to a thirty day review period by Congress.	
Florida	None	Tax is tied to federal state death tax credit. FL ST § 198.02; FL CONST. Art. VII, Sec. 5		
Georgia	None	Effective July 1, 2014, the Georgia estate tax was repealed. See § 48-12-1.		
Hawaii	Modified Pick-up Tax	Tax was tied to federal state death tax credit. HI ST §§ 236D-3; 236D-2; 236D-B The Hawaii Legislature on April 30, 2010 overrode the Governor's veto of HB 2866 to impose a Hawaii estate tax on residents and also on the Hawaii assets of a non-resident or a non US citizen.	On May 2, 2012, the Hawaii legislature passed HB2328 which conforms the Hawaii estate tax exemption to the federal estate tax exemption for decedents dying after January 25, 2012. On June 7,	$5,600,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
			2018, the governor signed SB 2821, which amended HI ST § 236E-6 to reduce the Hawaiian exemption, effective January 1, 2018, to $5,000,000 indexed for inflation.	
Idaho	None	Tax is tied to federal state death tax credit. ID ST §§ 14-403; 14-402; 63-3004 (as amended Mar. 2002).		
Illinois	Modified Pick-up Only	On January 13, 2011, Governor Quinn signed Public Act 096-1496 which increased Illinois' individual and corporate income tax rates. Included in the Act was the reinstatement of Illinois' estate tax as of January 1, 2011 with a $2 million exemption. Senate Bill 397 passed both the Illinois House and Senate as part of the tax package for Sears and CME on December 13, 2011. It increased the exemption to $3.5 million for 2012 and $4 million for 2013 and beyond. Governor Quinn signed		$4,000,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		the legislation on December 16, 2011. Illinois permits a separate state QTIP election, effective September 8, 2009. 35 ILCS 405/2(b-1).		
Indiana	None	Pick-up tax is tied to federal state death tax credit. IN ST §§ 6-4.1-11-2; 6-4.1-1-4.	On May 11, 2013, Governor Pence signed HB 1001 which repealed Indiana's inheritance tax retroactively to January 1, 2013. This replaced Indiana's prior law enacted in 2012 which phased out Indiana's inheritance tax over nine years beginning in 2013 and ending on December 31, 2021 and increased the inheritance tax exemption amounts retroactive to January 1, 2012.	
Iowa	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. IA ST § 451.2; 451.13. Effective July 1,		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		2010, Iowa specifically reenacted its pick-up estate tax for decedents dying after December 31, 2010. Iowa Senate File 2380, reenacting IA ST § 451.2. Iowa has a separate inheritance tax on transfers to others than lineal ascendants and descendants.		
Kansas	None	For decedents dying on or after January 1, 2007 and through December 31, 2009, Kansas had enacted a separate stand alone estate tax. KS ST § 79-15, 203		
Kentucky	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. KY ST § 140.130. Kentucky has not decoupled but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election.		
Louisiana	None	Pick-up tax is tied to federal state death tax credit. LA R.S. §§ 47:2431; 47:2432; 47:2434.		
Maine	Pick-up Only	For decedents dying after December 31, 2002, pick-up tax was frozen at pre-EGTRRA federal state death tax credit, and	Maine does not appear to have picked up the amendments made in the	$5,600,000 Estimated

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law) (L.D. 1319; March 27, 2003). On June 20, 2011, Maine's governor signed Public Law Chapter 380 into law, which will increase the Maine estate tax exemption to $2 million in 2013 and beyond. The rates were also changed, effective January 1, 2013, to 0% for Maine estates up to $2 million, 8% for Maine estates between $2 million and $5 million, 10 % between $ 5 million and $8 million and 12% for the excess over $8 million. On June 30, 2015, the Maine legislature overrode the Governor's veto of LD 1019, the budget bill for fiscal years 2016 and 2017. As part of the new law, the Maine Exemption is tagged to the federal exemption for decedents dying on or after January 1, 2016. The tax rates will be:	2017 federal tax reform act. For estates of decedents dying on or after January 1, 2016, the "Maine exclusion amount "means the basic exclusion amount determined for the calendar year in accordance with Section 2010(c)(3) of the "Code." 36 M.R.S. § 4102(5). However, Maine's tax law defines "Code" as the United States Internal Revenue Code of 1986 and any amendments to that Code as of December 31, 2016.	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		8% on the first $3 million above the Maine Exemption; 10% on the next $3 million above the Maine Exemption; and !2% on all amounts above $6 million above the Maine Exemption. The new legislation did not include portability as part of the Maine Estate Tax. For estates of decedents dying after December 31, 2002, Sec. 2058 deduction is ignored in computing Maine tax and a separate state QTIP election is permitted. M.R.S. Title 36, Sec. 4062. Maine also subjects real or tangible property located in Maine that is transferred to a trust, limited liability company or other pass-through entity to tax in a non-resident's estate. M.R.S. Title 36, Sec. 4064.		
Maryland	Pick-up Tax Inheritance Tax	On May 15, 2014, Governor O'Malley signed HB 739 which repealed and reenacted MD TAX GENERAL §§ 7-305, 7-309(a), and 7-309(b) to do the	On April 5, 2018, HB 0308 became law. The new law provides that for 2019 and thereafter, the	$4,000,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		following: 1. Increases the threshold for the Maryland estate tax to $1.5 million in 2015, $2 million in 2016, $3 million in 2017, and $4 million in 2018. For 2019 and beyond, the Maryland threshold will equal the federal applicable exclusion amount. 2. Continues to limit the amount of the federal credit used to calculate the Maryland estate tax to 16% of the amount by which the decedent's taxable estate exceeds the Maryland threshold unless the Section 2011 federal state death tax credit is then in effect. 3. Continues to ignore the federal deduction for state death taxes under Sec. 2058 in computing	Maryland threshold will be capped at the fixed amount of $5 million rather than being equal to the inflation-adjusted federal exemption as provided under prior law. The new law also provides for the portability of the unused predeceased spouse's Maryland exemption amount to the surviving spouse beginning in 2019.	

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		Maryland estate tax, thus eliminating a circular computation. 4. Permits a state QTIP election.		
Massachusetts	Pick-up Only	For decedents dying in 2002, pick-up tax is tied to federal state death tax credit. MA ST 65C §§ 2A. For decedents dying on or after January 1, 2003, pick-up tax is frozen at federal state death tax credit in effect on December 31, 2000. MA ST 65C §§ 2A(a), as amended July 2002. Tax imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. See, Taxpayer Advisory Bulletin (Dec. 2002), DOR Directive 03-02, Mass. Guide to Estate Taxes (2003) and TIR 02-18 published by Mass. Dept. of Rev.		$1,000,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		Massachusetts Department of Revenue has issued directive, pursuant to which separate Massachusetts QTIP election can be made when applying state's new estate tax based upon pre-EGTRRA federal state death tax credit.		
Michigan	None	Tax is tied to federal state death tax credit. MI ST §§ 205.232; 205.256		
Minnesota	Pick-up Only	Tax frozen at federal state death tax credit in effect on December 31, 2000, clarifying statute passed May 2002. Tax imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. MN ST §§ 291.005; 291.03; instructions for MS Estate Tax Return; MN Revenue Notice 02-16. Separate state QTIP election permitted.	On May 30, 2017, the governor signed the budget bill, H.F. No. 1 which increased the Minnesota estate tax exemption for 2017 from $1,800,000 to $2,100,000 retroactively, and increases the exemption to $2,400,000 in 2018, $2,700,000 in 2019, and $3,000,000 for 2020 and thereafter. A provision	$2,400,000

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
			enacted in 2013 to impose an estate tax on non-residents who own an interest in a pass-through entity which in turn owned real or personal property in Minnesota was amended in 2014 to exclude certain publicly traded entities. It still applies to entities taxed as partnerships or S Corporations that own closely held businesses, farms, and cabins.	
Mississippi	None	Tax is tied to federal state death tax credit. MS ST § 27-9-5.		
Missouri	None	Tax is tied to federal state death tax credit. MO ST §§ 145.011; 145.091.		
Montana	None	Tax is tied to federal state death tax credit. MT ST § 72-16-904; 72-16-905.		
Nebraska	County Inheritance	Nebraska through 2006 imposed a pick-up tax at		

	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
	Tax	the state level. Counties impose and collect a separate inheritance tax. NEB REV ST § 77-2101.01(1).		
Nevada	None	Tax is tied to federal state death tax credit. NV ST Title 32 §§ 375A.025; 375A.100.		
New Hampshire	None	Tax is tied to federal state death tax credit. NH ST §§ 87:1; 87:7.		
New Jersey	Inheritance Tax	For decedents dying after December 31, 2002, pick-up tax frozen at federal state death tax credit in effect on December 31, 2001. NJ ST § 54:38-1 Pick-up tax imposed on estates exceeding federal applicable exclusion amount in effect December 31, 2001 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount. The exemption will be increased to $2 million in 2017 and the pick-up tax, but the inheritance tax, will be eliminated as of January 1, 2018. The executor has the option of paying the	On October 14, Governor Christie signed Assembly Bill A-12 which was the tax bill accompanying the Assembly Bill A-10 which revised the funding for the state's Transportation Fund. Under this new law, the Pick-Up Tax will have a $2 million exemption in 2017 and will be eliminated as of January 1, 2018. The new law also eliminates the tax on New Jersey real and tangible property of a	

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		above pick-up tax or a similar tax prescribed by the NJ Dir. Of Div. of Taxn. NJ ST § 54:38-1; approved on July 1, 2002. In Oberhand v. Director, Div. of Tax, 193 N.J. 558 (2008), the retroactive application of New Jersey's decoupled estate tax to the estate of a decedent dying prior to the enactment of the tax was declared "manifestly unjust", where the will included marital formula provisions. In Estate of Stevenson v. Director, 008300-07 (N.J.Tax 2-19-2008) the NJ Tax Court held that in calculating the New Jersey estate tax where a marital disposition was burdened with estate tax, creating an interrelated computation, the marital deduction must be reduced not only by the actual NJ estate tax, but also by the hypothetical federal estate tax that would have been payable if the decedent had died in 2001. New Jersey allows a separate state QTIP election when a federal estate tax return is not	non-resident decedent. The repeal of the pick-up tax does not apply to the separate New Jersey inheritance tax.	

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		filed and is not required to be filed. The New Jersey Administrative Code also requires that if the federal and state QTIP election is made, they must be consistent. NJAC 18:26-3A.8(d)		
New Mexico	None	Tax is tied to federal state death tax credit. NM ST §§ 7-7-2; 7-7-3.		
New York	Pick-up Only	Tax frozen at federal state death tax credit in effect on July 22, 1998. NY TAX § 951. Governor signed S. 6060 in 2004 which applies New York Estate Tax on a *pro rata* basis to non-resident decedents with property subject to New York Estate Tax. On March 16, 2010, the New York Office of Tax Policy Analysis, Taxpayer Guidance Division issued a notice permitting a separate state QTIP election when no federal estate tax return is required to be filed such as in 2010 when there is no estate tax or when the value of the gross estate is too low to require the filing of a federal return. See TSB-M-10(1)M.	The Executive Budget of 2014-2015 which was signed by Governor Cuomo on March 31, 2014 made substantial changes to New York's estate tax. The New York estate tax exemption which was $1,000,000 through March 31, 2014 has been increased as follows: April 1, 2014 to March 31, 2015 -- $2,062,500	$5,250,000 April 1, 2017 through December 31, 2018)

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		Advisory Opinion (TSB-A-08(1)M (October 24, 2008) provides that an interest in an S Corporation owned by a non-resident and containing a condominium in New York is an intangible asset as long as the S Corporation has a real business purpose. If the S Corporation has no business purpose, it appears that New York would look through the S Corporation and subject the condominium to New York estate tax in the estate of the non-resident. There would likely be no business purpose if the sole reason for forming the S Corporation was to own assets.	April 1, 2015 to March 31, 2016 -- $3,125,000 April 1, 2016 to March 31, 2017 -- $4,187,500 April 1, 2017 to December 31, 2018 -- $5,250,000 As of January 1, 2019, the New York estate tax exemption amount will be the same as the federal estate tax applicable exclusion amount **prior** to the 2017 Tax Act which is $5,000,000 adjusted for inflation. The maximum rate of tax will continue to be 16%. Taxable gifts within three years of death between April	

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			1, 2014 and December 31, 2018 will be added back to a decedent's estate for purposes of calculating the New York tax. The New York estate tax will be a cliff tax. If the value of the estate is more than 105% of the then current exemption, the exemption will not be available. On April 1, 2015, as part of 2015-2016 Executive Budget, New York enacted changes to the New York Estate Tax. New York first clarified that the new rate schedule enacted in 2014 applies to all decedents dying after April 1, 2014. Previously, the	

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			rate schedule only applied through March 31, 2015. New York then modified the three year gift add-back provision to make it clear that the gift add-back does not apply to any individuals dying on or after January 1, 2019. Previously, the gift add-back provision did not apply to gifts made on or after January 1, 2019. New York continues to not permit portability for New York estates and no QTIP election is allowed.	
North Carolina	None		On July 23, 2013, the Governor signed HB 998 which repealed the North Carolina estate tax retroactively to	

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			January 1, 2013.	
North Dakota	None	Tax is tied to federal state death tax credit. ND ST § 57-37.1-04		
Ohio	None	Governor Taft signed the budget bill, 2005 HB 66, repealing the Ohio estate (sponge) tax prospectively and granting credit for it retroactively. This was effective June 30, 2005 and killed the sponge tax. On June 30, 2011, Governor Kasich signed HB 153, the biannual budget bill, which contained a repeal of the Ohio state estate tax effective January 1, 2013.		
Oklahoma	None	Tax is tied to federal state death tax credit. OK ST Title 68 § 804 The separate estate tax was phased out as of January 1, 2010.		
Oregon	Separate Estate Tax	On June 28, 2011, Oregon's governor signed HB 2541 which replaces Oregon's pick-up tax with a stand-alone estate tax effective January 1, 2012. The new tax has a $1 million threshold with rates increasing from ten percent to sixteen percent between $1 million and $9.5 million.		$1,000,000

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		Determination of the estate for Oregon estate tax purposes is based upon the federal taxable estate with adjustments.		
Pennsylvania	Inheritance Tax	Tax is tied to the federal state death tax credit to the extent that the available federal state death tax credit exceeds the state inheritance tax. PA ST T. 72 P.S. § 9117 amended December 23, 2003. Pennsylvania had decoupled its pick-up tax in 2002, but has now recoupled retroactively. The recoupling does not affect the Pennsylvania inheritance tax which is independent of the federal state death tax credit. Pennsylvania recognizes a state QTIP election.		
Rhode Island	Pick-up Only	Tax frozen at federal state death tax credit in effect on January 1, 2001, with certain adjustments (see below). RI ST § 44-22-1.1. Rhode Island recognized a separate state QTIP election in the State's Tax Division Ruling Request No. 2003-03. Rhode Island's Governor	On June 19, 2014, the Rhode Island Governor approved changes to the Rhode Island Estate Tax by increasing the exemption to $1,500,000 indexed for inflation in 2015 and	$1,537,656

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		signed into law HB 5983 on June 30, 2009, effective for deaths occurring on or after January 1, 2010, an increase in the amount exempt from Rhode Island estate tax from $675,000, to $850,000, with annual adjustments beginning for deaths occurring on or after January 1, 2011 based on "the percentage of increase in the Consumer Price Index for all Urban Consumers (CPI-U). . . rounded up to the nearest five dollar ($5.00) increment." RI ST § 44-22-1.1.	eliminating the cliff tax.	
South Carolina	None	Tax is tied to federal state death tax credit. SC ST §§ 12-16-510; 12-16-20 and 12-6-40, amended in 2002.		
South Dakota	None	Tax is tied to federal state death tax credit. SD ST §§ 10-40A-3; 10-40A-1 (as amended Feb. 2002).		
Tennessee	None	Pick-up tax is tied to federal state death tax credit. TN ST §§ 67-8-202; 67-8-203. Tennessee had a separate inheritance tax which was phased out as of January 1, 2016.	On May 2, 2012, the Tennessee legislature passed HB 3760/SB 3762 which phased out the Tennessee Inheritance Tax	

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			as of January 1, 2016. The Tennessee Inheritance Tax Exemption was increased to $1.25 million in 2013, $2 million in 2014, and $5 million in 2015. On May 2, 2012, the Tennessee legislature also passed HB 2840/SB2777 which repealed the Tennessee state gift tax retroactive to January 1, 2012.	
Texas	None	Tax was permanently repealed effective as of September 15, 2015 when Chapter 211 of the Texas Tax Code was repealed. Prior to September 15, 2015, the tax was tied to the federal state death tax credit.		
Utah	None	Tax is tied to federal state death tax credit. UT ST § 59-11-102; 59-11-103.		
Vermont	Modified Pick-up	In 2010, Vermont increased the estate tax exemption threshold from $2,000,000 to $2,750,000		$2,750,000

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		for decedents dying January 1, 2011. As of January 1, 2012 the exclusion is scheduled to equal the federal estate tax applicable exclusion, so long as the FET exclusion is not less than $2,000,000 and not more than $3,500,000. VT ST T. 32 § 7442a. Previously the estate tax was frozen at federal state death tax credit in effect on January 1, 2001. VT ST T. 32 §§ 7402(8), 7442a, 7475, amended on June 21, 2002. No separate state QTIP election permitted.		
Virginia	None	Tax is tied to federal state death tax credit. VA ST §§ 58.1-901; 58.1-902. The Virginia tax was repealed effective July 1, 2007. Previously, the tax was frozen at federal state death tax credit in effect on January 1, 1978. Tax was imposed only on estates exceeding EGTRRA federal applicable exclusion amount. VA ST §§ 58.1-901; 58.1-902.		
Washington	Separate Estate Tax	On February 3, 2005, the Washington State Supreme Court	On June 14, 2013, Governor Inslee signed	$2,193,000

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		unanimously held that Washington's state death tax was unconstitutional. The tax was tied to the current federal state death tax credit, thus reducing the tax for the years 2002 - 2004 and eliminating it for the years 2005 - 2010. Hemphill v. State Department of Revenue 2005 WL 240940 (Wash. 2005). In response to Hemphill, the Washington State Senate on April 19 and the Washington House on April 22, 2005, by narrow majorities, passed a stand-alone state estate tax with rates ranging from 10% to 19%, a $1.5 million exemption in 2005 and $2 million thereafter, and a deduction for farms for which a Sec. 2032A election could have been taken (regardless of whether the election is made). The Governor signed the legislation. WA ST §§ 83.100.040; 83.100.020. Washington voters defeated a referendum to repeal the Washington estate tax in the November 2006 elections. Washington permits a	HB 2075 which closed an exemption for marital trusts retroactively immediately prior to when the Department of Revenue was about to start issuing refund checks, created a deduction for up to $2.5 million for certain family owned businesses and indexes the $2 million Washington state death tax threshold for inflation.	

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		separate state QTIP election. WA ST §83.100.047.		
West Virginia	None	Tax is tied to federal state death tax credit. WV § 11-11-3.		
Wisconsin	None	Tax is tied to federal state death tax credit. WI ST § 72.01(11m). For deaths occurring after September 30, 2002, and before January 1, 2008, tax was frozen at federal state death tax credit in effect on December 31, 2000 and was imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount. Thereafter, tax imposed only on estates exceeding EGTRRA federal applicable exclusion amount. WI ST §§ 72.01; 72.02, amended in 2001; WI Dept. of Revenue website. On April 15, 2004, the Wisconsin governor signed 2003 Wis. Act 258, which provided that		

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		Wisconsin will not impose an estate tax with respect to the intangible personal property of a non-resident decedent that has a taxable situs in Wisconsin even if the non-resident's state of domicile does not impose a death tax. Previously, Wisconsin would impose an estate tax with respect to the intangible personal property of a non-resident decedent that had a taxable situs in Wisconsin if the state of domicile of the non-resident had no state death tax.		
Wyoming	None	Tax is tied to federal state death tax credit. WY ST §§ 39-19-103; 39-19-104.		

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