Estate and Transfer Planning Under the "New Normal"

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Steve R. Akers

Senior Fiduciary Counsel — Southwest Region, Bessemer Trust
300 Crescent Court, Suite 800
Dallas, TX 75201
214-981-9407
akers@bessemer.com
www.bessemer.com

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Introduction

This summary of estate and transfer planning under the “new normal” includes a discussion of various current developments.

1. Overview of Transfer Planning Strategies and General Planning Considerations for Gifts

a. **Basics of Gifting Strategies**. The traditional basic gifting strategy is to make gifts without generating a federal gift tax.

Annual Exclusion and Medical/Tuition Exclusion Gifts. The first level of gifting is to make gifts within the $14,000 annual exclusion amount. I.R.C. § 2503(b)(1). Furthermore, clients may make gifts for medical expenses or tuition expenses directly to the medical care or education provider, without gift or GST tax consequences. I.R.C. § 2503(e). Annual exclusion gifts are the first level of gifting strategy because if gifts are not made in a particular calendar year to fully utilize the annual exclusion for that year, it is lost forever.

Applicable Exclusion Amount Gifts. Gifts in excess of the annual exclusion amounts or medical/tuition exclusion for any particular year first “use up" part of the donor’s lifetime "applicable exclusion amount". Until 2011, the applicable exclusion amount for gift tax purposes was fixed at $1 million. The gift applicable exclusion amount is now the same as the estate applicable exclusion amount--$5,430,000 for 2015 (likely going to $5,450,000 in 2016). Aggregate lifetime gifts up to the "gift exemption amount" can be made without generating current federal gift tax.

Excess Gifts. Gifts in a year that are not covered by annual exclusions and that exceed the aggregate lifetime gift exemption amount will be subject to current federal gift taxes, at a maximum 40% rate. Even though such excess gifts are subject to the payment of a current gift tax, the overall taxes may be significantly reduced by making transfers subject to the gift tax than by retaining the assets and having them subject to the estate tax. The estate tax is calculated based on the entire estate, including the amount paid as estate taxes, whereas the gift tax rate is applied only to the assets actually passing to donees. In order to get this benefit, the donor must live at least three years after making the gift; otherwise the gift tax is brought back into the estate. I.R.C. § 2035(b). However, most clients want to avoid paying current gift taxes.

b. **Freezing Strategies**. For the client who has "maxed out" on annual exclusions and applicable exclusion amount gifts, the next strategy is estate freezing. The goal would be to freeze the value of assets to be included in the donor’s estate at its current value (or at its current value boosted by a specified interest rate factor.) A classic example would be for a parent to sell assets to a child. The asset that was sold is not included in the parent’s estate, but only the note (together with accrued interest) will be in the estate. The problem with a classic installment sale is that income tax can be generated on the sale.

GRATs, sales to a grantor trusts, and CLATs are all techniques for freezing a substantial portion of the current value in the estate without generating a current gift or income tax. For an excellent summary describing and comparing GRATs and sales to grantor trusts, see Blattmachr & Zeydel, *Comparing GRATs and Installment Sales*, 41ST ANNUAL HECKERLING INST. ON ESTATE PLANNING ch. 2 (2007).

c. **Overview of Tax Effects of Gifts**. The following is a brief summary of the tax effects of gifts.

A donor can make gifts of the full additional gift exemption amount without paying gift tax.

Gifts are not removed from the base for calculating estate tax, but making gifts does not result in increasing the aggregate combined transfer taxes.

Despite the fact that gifts are included in the base for calculating the estate tax, tax advantages of making gifts include:

- removal of appreciation/income of gift assets from the gross estate;
- utilizing fractionalization discounts;
- paying income taxes on income from grantor trusts to further "burn" the donor's gross estate;
- if the donor lives three years, gift taxes paid are removed from the gross estate; and
- the ability to allocate GST exemption so that the same advantages apply for generation-skipping purposes as well;
- removing assets from the donor's gross estate for state estate tax purposes without payment of any federal or state transfer taxes (assuming the state does not have a state gift tax or "contemplation of death" recapture of gifts back into the state gross estate); and

The most obvious non-tax advantage of making gifts is to allow donees to enjoy the gift assets currently.

Perhaps the most important advantage of the increased gift exemption for many individuals will be the "cushion" effect — the ability to make gifts in excess of $1 million, but considerably less than the $5 million indexed amount, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even if "aggressive" valuations are used), which may lessen the perceived necessity to use defined value clauses to avoid paying gift taxes in making transfers.

Gifts can be disadvantageous from an overall tax cost perspective if (i) the gift asset declines in value after making the gift (which uses up gift exclusion based on the date of gift value), or (ii) if the loss of a basis step-up more than offsets the estate tax savings as a result of removing appreciation/income from the asset and the other advantages of gifts listed above.

d. **Basis Concerns**. The differential between the 45% estate tax rate and a 23.8% capital gains rate makes the basis concerns significant. The advantage of making a gift is that the appreciation is not subject to estate tax; but the disadvantage is that there is no step up in basis for that asset at death. Stated differently, there may be have to be a substantial amount of appreciation in order for the 45% estate tax savings on that appreciation to offset the loss of basis step up on the *full* value of the asset.

For example, a gift of a $1 million asset with a zero basis would have to appreciate to approximately $2,470,000 (to a value that is 247% of the current value) in order for the estate tax savings on the future appreciation ($1,469,135 x 40%) to start to offset the loss of basis step-up ((2,469,135 x 23.8% for high bracket taxpayers). The

required appreciation will be even more if there are also state income taxes on the capital gains..

Keep in mind that the income tax is incurred only if the family sells the asset. If the family will retain the asset indefinitely, or if real estate investment changes could be made with §1031 like kind exchanges, basis step up is not an important issue.

Strategies are available to avoid the loss of basis step up if gifts are made to grantor trusts. The grantor can repurchase the low-basis assets before death, so that the low-basis assets would be in the gross estate at death and get a step-up in basis under §1014. (This could be worthwhile even if the grantor has to borrow money to be able to repurchase the low basis assets and get cash into the grantor trust — which does not need a stepped-up basis.) In addition, some commentators maintain that a basis step up is available under §1014 at the grantor's death for all assets in a grantor trust. Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death,* 97 J. TAX'N 148 (Sept. 2002).

e. **Basis Step-Up Flexibility; Repurchase of Assets by Grantor, Triggering "String" Provision**. Consider steps to build in flexibility for achieving a basis step-up at the death of a transferor. Key to this flexibility will be making the gift to a trust rather than an outright gift. Various strategies are discussed below.

Exercise Swap Power to Acquire Low Basis Assets Held by Grantor Trust. The grantor may pay cash to the grantor trust to acquire low-basis assets (so that the assets will achieve a basis adjustment at the grantor's death). If the grantor purchases the assets for a note, it is uncertain what basis the trust will have in the note—and whether future payments may generate gain to the trust. If the grantor does not have sufficient cash to make the purchase, the grantor may borrow cash from a third party lender to make the purchase. See Item 7.b below. Consider using a defined value clause in exercising the substitution power to minimize possible gift issues. Advise the client of the possibility of disclosing this "non-gift" transaction on a gift tax return and making adequate disclosure to start the statute of limitations on gift tax assessments. (Interestingly, the adequate disclosure regulations do not require that an appraisal be attached to a return reporting a "non-gift" transaction.)

If No Swap Powers, Negotiate Sale With Trustee. If the grantor does not have a substitution power, the grantor could negotiate to purchase low basis assets from the grantor trust.

Convert to Grantor Trust. If the trust is not a grantor trust, consider taking steps to convert the trust to a grantor trust so that the grantor can acquire the low basis assets from the trust in a non-taxable transaction. Possible strategies include a court modification to include a substitution power of other grantor trust "trigger" power, decanting to a grantor trust, or borrowing from the trust.

Section 2036/2038 Inclusion. The settlor might become the custodian of an UTMA account or the trustee of a trust that does not have determinable standard for distributions. Alternatively, multiple settlors might invoke the reciprocal trust doctrine. Missteps in the correct operation of a transfer planning strategy (which can happen with the best of intentions) may support an argument of an implied agreement of retained enjoyment. This could include such things as continuing to use the trust assets without paying fair market rental value or making installment payments on sales transactions with a grantor trust with entity distributions that match the note payment

amounts. However, the intention of the grantor at the time of the original transfer is what is determinative under §2036. If at that time the grantor did not intend to retain use of the asset, subsequent intentional "missteps" should not trigger §2036. *See Estate of Riese v. Commissioner*, T.C. Memo. 2011-60 (lease payments were not made for settlor's continued use of residence after termination of QPRT term within the 6-month period from the termination date to the date of her death; IRS argued that reflected an implied agreement of retained enjoyment; court determined that she had intended to pay rent but the attorneys had merely not determined rental payments and prepared a lease prior to her death and "[t]there was no understanding, express or implied, at the time of transfer that decedent could occupy the residence rent free").

This issue of looking back to intent at the time of the original gift does not apply to §2038 inclusion. Therefore a court modification to add the grantor as a co-trustee (if there is not a "determinable interest" standard on distributions) or to give the grantor a limited power of appointment among the class of beneficiaries would trigger §2038 inclusion.

Independent Party Granting Limited Power of Appointment to Grantor. Another approach is to draft the trust to give an independent trustee or other independent party the power to grant a testamentary limited power of appointment to the grantor. The limited power of appointment could be as broad or narrow as desired, as long as it allowed the possibility of shifting benefits from beneficiary to another. If so granted, this would cause inclusion in the grantor's estate under § 2038 (and that section is based on powers that the grantor actually holds at death and not on the retention of interests at the time of the original transfer). To protect the independent third party, the instrument might exonerate the independent party from liability with respect to the decision to grant the power of appointment regardless of whether it is exercised. The instrument could provide that the independent third party has no obligation to inquire as to whether the authority should be exercised. Another approach would be to provide that the independent party has no authority to grant the power of appointment until requested in writing to do so by a designated class of persons.

The grant of the testamentary power of appointment to the grantor could conceivably be by a formula. The trust instrument could give the donor a formula testamentary power of appointment to the extent that an amount equal to 40% of the excess of the date of death value over the date of gift value is less than amount equal to 23.8% of the excess of the date of death value over the basis of the property (substituting the current tax rates). The disadvantage of the formula approach, if it operates immediately after the creation of the trust, is that it creates an ETIP, which would preclude immediate allocation of GST exemption to the trust.

Beneficiary Argue for Estate Inclusion. If a decedent did not include on the estate tax return an asset that had been transferred, can a beneficiary later make the argument (for income tax purposes) that the decedent should have included that asset on the estate tax return (because he used the asset without paying rent, because there was a sale to a grantor trust in which every dollar of income was used to make note payments, etc.)? Presumably so. The beneficiary certainly can claim that the actual value at the date of death was different than the value reported on the estate tax return (as long as the beneficiary was not the executor that filed the estate tax return). Rev. Rul. 54-97.

Purchase Remainder Interest in GRAT. If a GRAT has substantial value in highly appreciated assets that will ultimately pass to a remainder trust following the GRAT term, the grantor might purchase the remaindermen's interest in the GRAT (if there is not a spendthrift clause prohibiting that sale of the remainder interest). The grantor will own all assets in the trust, so the GRAT will terminate by merger. The GRAT regulations prohibit a "commutation" of the grantor's interest, but this is the opposite of that. The grantor will own the appreciated assets at death to achieve a basis adjustment. For further details, see Item 28.k of the Hot Topics and Current Developments Summary (December 2014) found here and available at www.Bessemer.com/Advisor.

Move Trust Situs to State Without Domestic Asset Trust Protection. The grantor may have created a trust with the grantor as a discretionary beneficiary that is sitused in a state with a domestic asset protection trust statute (so that the grantor's creditors cannot reach the trust, which likely prevents the grantor from having a retained enjoyment under §2036). Change the situs and applicable governing law so that the trust is no longer protected from the grantor's creditors, which may cause §2036 to apply.

f. **Keep in Mind Downside of Depreciation**. If the gifted asset depreciates in value, the client will be worse off, from a transfer tax standpoint, than if the gift had not been made in first place.

g. **How Much Can The Client Afford to or Want to Give? Desire to Retain Possible Indirect Benefits**? Spouses collectively could give up to $10 million without having to pay gift taxes. Clients may have a concern that gifts of $5 million ($10 million from a couple) are too much for their children (or trusts for their children) to receive. Howard Zaritsky (Rapidan, Virginia) gives the following standard cautionary advice to clients contemplating gifts to their children:

"(1) The gifts are likely to save a substantial amount of taxes;

(2) The child will not say 'thank you;'

(3) The parent will not approve of what the child does with the gift; and

(4) The child will not love the parent more for having made the gift."

Furthermore, few couples can afford to give $10 million without potentially impacting their lifestyle in later years. A primary concern will be "Will I have enough left to live on?" How do you define what are "discretionary" assets? That is not for the planner to define. "It's not the actual ability to make a gift that matters — it's the *perceived* ability to make a gift and maintain one's standard of living into the foreseeable future that matters." As a result, donors interested in making large additional gifts may want to consider the possibility of ways to preserve direct or indirect access to gift assets in the event of a "rainy day" financial reversal (strategies are discussed in Item 11below).

2. Treasury-IRS Priority Guidance Plan

a. **Overview.** The Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015 was released on July 31, 2015; it is available at http://www.irs.gov/pub/irs-utl/2015-2016_pgp_initial.pdf. Two items from last year's list for Gifts, Estates and

Trusts have been eliminated because of the issuance of final regulations: final regulations under §67 and the final portability regulations.

The 2015-2016 Plan includes the new item in last year's Priority Guidance Plan: "Revenue Procedure under §2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability." This will likely make clear that QTIP trusts can be used in connection with portability planning even if the QTIP election is not needed to reduce the estate tax in the first decedent's estate, despite the provisions of Revenue Procedure 2001-38. (Rev. Proc. 2001-38 appears to give estates the option of electing to treat the unneeded QTIP election as null and void; a revenue procedure announcing the Service's administrative forbearance cannot negate an election clearly authorized by statute.) The preamble to the portability final regulations (T.D. 9725) addresses the effect of the portability election on the application of Rev. Proc. 2001-38 in a cursory fashion: "The Treasury Department and the IRS intend to provide guidance, by publication in the Internal Revenue Bulletin, to clarify whether a QTIP election made under section 2056(b)(7) may be disregarded and treated as null and void when an executor has elected portability of the DSUE amount under section 2010(c)(5)(A)." (The preamble does not mention that an example in the temporary regulation regarding the application of the exception from having to report to values for certain property applies in a situation involving a trust for which a QTIP election was made, Reg. §20.2010-2T(a)(7)(C) Ex.2, was revised to omit the reference to a QTIP election.). Planners had been hopeful that this issue would be clarified in connection with the finalizing of the portability regulations by June 15, 2015 (which is the only new item on this year's list of projects in the Gifts and Estates and Trusts section of the Priority Guidance Plan for 2014-2015). One wonders why this guidance regarding Rev. Proc. 2001-38 is taking so long. Perhaps the IRS wants to craft a solution dealing with situations in which the portability election is made and QTIP assets decline in value by the time of the surviving spouse's death to keep the executor from being able to invoking Rev. Proc. 2001-38 to keep the assets from being included in the surviving spouse's gross estate in order to avoid a step-DOWN in basis under §1014.

There are four new items in the 2015-2016 Plan:

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

As to the new item regarding the *basis of grantor trust assets* under §1014, some commentators take the position that the deemed change of ownership for income tax purposes at the grantor's death (from the grantor to the trust) constitutes the receipt of

property from a decedent for purposes of §1014, and that there should be a basis step up even though the assets are not included in the gross estate. *See* Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. TAX'N 149 (Sept. 2002). The IRS recently added to its "no-ruling" list that it will not issue rulings as to "[w]hether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code." Rev. Proc. 2015-37. See Item 2.d.(1) below for a discussion of that no-ruling position and related authorities. *See also* Item 6.k below.

As to the new item dealing with the *valuation of promissory notes*, some examining agents have taken the position in gift tax audits that promissory notes bearing interest at the AFR should not be treated as being worth the face amount of the note, but have been reluctant to allow discounts in valuing such notes for estate tax purposes. (Section 7872(i)(2) specifically authorizes the issuance of regulations addressing the valuation of notes for estate tax purposes in light of §7872. Proposed Regulation §20.7872-1 addresses the valuation of a "gift term loan" for estate tax purposes, but that regulation has never been finalized.)

The new item regarding *defined value formula clauses* suggests that the IRS will eventually issue regulations regarding the effect of defined value formula clauses, despite its losses in the *McCord, Christianson, Petter, Hendrix* and *Wandry* cases.

These three issues all relate to sales to grantor trusts, suggesting that issues related to sales to grantor trusts are major "radar screen" issues for the IRS.

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

- Final regulations under §2032A regarding imposition of restrictions on estate assets during the six month alternate valuation period (this project first appeared in the 2007-2008 plan and proposed regulations were published in November 2011);
- Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against an estate (this project first appeared in the 2008-2009 plan);
- Regulations under §2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP (for example, the allocation of GST exemption to trusts created under a GRAT at the end of the initial GRAT term) (this project first appeared on the 2012-2013 plan);
- Final regulations under §2642(g) regarding extensions of time to make allocations of the GST exemption (this project first appeared in the 2007-2008 plan and proposed regulations were published in April, 2008);
- Regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships (this item first appeared in the 2003-2004 plan) (**there are indications that Treasury and IRS officials are currently working on this proposal, so proposed regulations might conceivably be issued at some point during 2015**); and

- Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates (this item first appeared in the 2009-2010 plan to implement the provisions of the "HEART Act" of 2008; this is consistently referred to by Treasury and IRS personnel as a top priority, but the implementation of what amounts to a transfer tax on transferees or their estates is complicated).

b. **Items of Highest Priority**. Cathy Hughes (with the Treasury Department) provided insight at the recent ABA Tax Section meeting as to the regulation projects impacting estate planners that we might expect to see in the near future. Projects that she mentioned include: (1) Final portability regulations (the temporary regulations expire June 15, 2015); (2) Guidance under the ABLE Act allowing states to create "Section 529-type" accounts for the disabled (which has now been issued); (3) Final regulations regarding basis rules for term interests in charitable remainder trusts (which were issued on August 11, 2015); (4) Guidance regarding the §2801 tax on gifts by certain expatriates to U.S. citizens and residents (this has been a "high priority" for several years); and after that guidance is issued (5) Section 2704 proposed regulations. (The preceding information is based on a summary of the ABA Tax Section meeting by Diane Freda. Freda, *Guidance on Material Participation For Trusts, Estates May Emerge in Stages*, BNA Daily Tax Report (May 12, 2015).)

At the ABA Tax/Real Property Probate and Trust Law Section Joint Meeting on September 18, 2015 Cathy Hughes indicated that the IRS/Treasury is still working on the Section 2704 proposed regulations. They are "getting closer" but they cannot predict when the new rules will be issued. She gave no further indications regarding the scope of the rules or their effective date. This summary suggests that the §2704 regulations will not be issued within the next several months but might conceivably be issued this fall or in 2016.

c. **Section 2704 Project**.

(1) *Overview.* Section 2704(b)(4) gives the Treasury broad authorization to issue regulations that would disregard certain "other restrictions" in determining the value of an interest in a corporation or partnership transferred to a family member if the restriction "does not ultimately reduce the value of such interest to the transferee." IRS and Treasury officials hinted about eight years ago that they were close to issuing such a proposed regulation (reflecting a §2704 guidance project that was placed on the IRS/Treasury Priority Guidance Plan in 2003), but President Obama's first budget proposal included a revenue proposal to revise §2704, and the §2704 regulation project was put on hold pending the possible passage of such legislation that might provide legislative support for the positions the new proposed regulation might take. Not a single bill was ever introduced addressing the legislative proposal, however, and the §2704 legislative proposal was omitted from the President's budget proposal released in February 2012.

IRS and Treasury officials have indicated that the §2704 regulation project is proceeding. Cathy Hughes, a Treasury official, had some comments about the §2704 regulation project at the recent ABA Tax Section meeting. The proposed regulation

may have a dramatic impact on the valuation of interests in closely-held corporations or partnerships that are transferred to family members—and the proposed regulation might conceivably be effective when the regulation is finalized retroactive to the date of the proposed regulation.

(2) *Section 2704 Statutory Background*. Section 2704 was enacted in 1990 as a part of Chapter 14. The goal in particular was to limit discounts for certain family partnership or LLC interests that are transferred to family members. Section 2704(b) is titled "Certain Restrictions on Liquidation Disregarded." It provides that any "applicable restriction" is disregarded in valuing an interest in a corporation or partnership that is transferred to a family member if the transferor and family members control the entity. An "applicable restriction" is any restriction that (i) effectively limits the ability of the corporation or partnership to liquidate, and (ii) the restriction lapses (entirely or partially) after the transfer OR the transferor or family members can remove the restriction (entirely or partially), but an "applicable restriction" does not include "any restriction imposed, or required to be imposed, by any Federal or State law" (or commercially reasonable restrictions imposed by unrelated persons in a financing transaction).

Section 2704(b)(4) includes broad legislative authority for the IRS to issue regulations that would disregard "other restrictions":

> "The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee."

The title to §2704(b) is "Certain Restrictions on Liquidation Disregarded." The authorization of regulatory authority in §2704(b)(4) does not specifically limit the regulations to "other liquidation restrictions" but merely refers to "other restrictions." Does this provide legislative authority for regulations limiting discounts for reasons other than merely disregarding liquidation restrictions despite the title of §2704(b)?

(3) *Significance of State Law Exception.* The exception for "any restriction imposed, or required to be imposed, by any Federal or State law" is very important. The "state law" exception is clearly integrated into the existing regulations.

> "An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction…. Ability to remove the restriction is determined by reference to the State law that would apply but for a more restrictive rule in the governing instrument of the entity…. A restriction imposed or required to be imposed by Federal or State law is not an applicable restriction." Treas. Reg. §25.2702-2(b).
>
> "(c) *Effect of disregarding an applicable restriction.*—If an applicable restriction is disregarded under this section, the transferred interest is valued as if the restriction does not exist and as if the rights of the transferor are determined

under the State law that would apply but for the restriction." Treas. Reg. §25.2704-2(c).

The exception for restrictions imposed by State law has dramatically reduced the applicability of §2704 to partnership and LLC transfers. Many state legislatures have revised limited partnership and LLC laws after the passage of §2704 to provide various limitations on the rights of limited partners or LLC members to make transfers under default rules that apply unless the partnership or operating agreement specifically overrides those default rules.

(4) *Possible Scope of New §2704 Proposed Regulation*. Cathy Hughes said that the scope of what the new regulations might include are indicated by the §2704 legislative proposal (last included in the Fiscal Year 2013 Greenbook, "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals" dated February 2012). (This suggests that the new proposed regulations may include many of the items that were being considered eight years ago. The Treasury presumably suggested the §2704 legislative project to the Obama administration to support the provisions that it wanted to include in its new regulations.)

The §2704 legislative proposal in the Greenbooks for the Obama administration, ending with the 2013 Fiscal Year Greenbook, includes five items. The new §2704 regulation may include some or all of these subjects.

(i) *Additional "Disregarded Restrictions*." An additional category of restrictions ("disregarded restrictions," which are in addition to the liquidation restrictions addressed in §2704) may be disregarded in determining the value of interests in "family-controlled entities" (observe, this is not limited just to partnerships and LLCs) that are transferred to family members. What are those additional restrictions? They are "to be specified in regulations." Transferred interests would be valued by substituting for "disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations. "

(ii) *Assignee Interests*. Restrictions on a transferee being able to become a full-fledged partner (or member of an LLC) would be a disregarded retriction.

(iii) *Third Party Involvement in Removing Restrictions*. Section 2704(b)(2)(B)(ii) says that one of the general requirements of an "applicable restriction" is that the transferor or family members can remove the restriction. (The Greenbook proposal generally retains this family-removal requirement with respect to "disregarded restrictions.") The Fifth Circuit in the *Kerr* case reasoned that §2704 did not apply to the partnership in that case because charities had small limited partnership interests, and all partners had to consent to removing restrictions; thus, the family acting alone could not remove the restrictions. *Kerr v. Commissioner*, 292 F.3d 490 (5th Cir. 2002). Under the legislative proposal, "certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family."

(iv) *Safe Harbor*. The statute would provide regulation authority that would include "the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met."

(v) *Marital and Charitable Deduction*. The legislation would include provisions dealing with the interaction of the marital and charitable deductions for transfer tax purposes. Therefore, if an interest is valued higher than its actual fair market value for transfer tax purposes, the higher value might also be applied for marital deduction and charitable deduction purposes (a taxpayer-friendly provision).

Richard Dees (Chicago, Illinois) wrote a 29-page letter to the Assistant Secretary of Tax Policy in the Treasury Department and to the Commissioner of the Internal Revenue Service on August 31, 2015, in which he maintains that if the regulation implements the provisions in the statutory proposal, the regulation "would be invalid as contrary to the origin, purpose and scope of the current statute." The letter provides a detailed summary of the statutory provisions in §2704, the legislative history behind §2704, and case law interpreting §2704 to support his position. Some of his reasoning is that the origin and intent of §2704 was "only to disregard liquidation provisions and other provisions of organizational documents that lowered the value of interest in a family business for transfer tax purposes below what would occur under state law if those provisions were not in the documents." He argues that §2704(b) only empowers the IRS to *disregard* certain restrictions in family entity organizational documents, but not to replace those disregarded provisions with IRS-invented alternatives "that would make the valuation of minority interests in a family business the same as if family attribution applied;" instead the balance of the provisions in the documents that are not disregarded and provisions supplied by the operation of state law would be considered in valuing the transferred interest.

(5) *Effective Date*. Treasury regulations are typically effective on the date final regulations are issued. At least several years typically lapse from the time proposed regulations are issued until the regulations are finalized. In very limited situations, proposed regulations provide they will be effective when finalized retroactive back to the date of the proposed regulations. For example, the proposed regulations regarding the income tax effects of private annuities issued in 2006 take that approach (and interestingly, those regulations still have not been finalized, nine years after the proposed regulations were issued, *see* REG-141901-05k proposing changes to Reg. §§1.72-6(e) & 1.100(j)). The initial "anti-Kohler" proposed regulations that were issued in 2008 also took that "retroactive effect" approach, but the revised proposed regulation issued in 2011 dropped that harsh effective date provision. *See* Prop. Treas. Reg. §20.2032-1(f). Cathy Hughes suggested at the ABA Tax Section meeting that the Treasury and IRS are still considering what should be the appropriate effective date of the proposed regulation.

(6) *Legislative History*. Some planners have expressed concern that the proposed regulation may limit the availability of minority and marketability discounts for transfers involving family-controlled entities. *See* Freda, *Guidance on Material Participation For Trusts, Estates May Emerge in Stages*, BNA Daily Tax Report (May

12, 2015) (summarizing comments of Richard Dees). The legislative history (the 1990 Conference Report) makes clear that Chapter 14 was not intended to "affect minority discounts or other discounts available under [former] law." The Senate's discussion of the former law and the impact of Chapter 14 is rather emphatic.

> "The value of property transferred by gift or includable in the decedent's gross estate generally is its fair market value at the time of the gift or death. Fair market value is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (Treas. Reg. sec. 20.2031-1(b)). This standard looks to the value of the property to a hypothetical seller and buyer, not the actual parties to the transfer. Accordingly, courts generally have refused to consider familiar relationships among co-owners in valuing property. For example, courts allow corporate stock to be discounted to reflect minority ownership even when related persons together own most or all of the underlying stock.
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> . . . .
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> *The bill does not affect minority discounts or other discounts available under present law.*
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> . . . .
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> *. . . the bill does not affect the valuation of a gift of a partnership interest if all interests in the partnership share equally* in all items of income, deduction, loss and gain in the same proportion *(i.e.*, straight-up allocations)." (136 Cong. Rec. § 15679, 15681 (October 18, 1990) (emphasis added)).
>
> Perhaps the existence of this legislative history is the reason that the IRS beginning in 2009 sought legislative changes to §2704 before issuing its new proposed regulations.

d. **Surprises.** The IRS has recently released several items of interest for which there was no warning in the Priority Guidance Plan.

(1) *Basis of Assets Transferred to Grantor Trust at Grantor's Death.* Some commentators have taken the position that assets in the grantor trust that were transferred to the trust from the grantor should receive a basis step-up at the grantor's death. *See* Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 49 (Sept. 2002). The article observes that the basis step-up under §1014 is not limited to assets included in a decedent's gross estate for estate tax purposes. While §1014 provides for a basis adjustment to the date of death value for property included in a decedent's gross estate, there are various other situations in which property that is "acquired from a decedent" will receive a basis adjustment, detailed in nine subsections of §1014(b). Section 1014(b)(9) is the "included in the decedent's gross estate" section, but other subsections are far more general, including subsection (b)(1) which simply refers to "property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." (An example of an asset not in a decedent's gross estate for estate tax purposes that receives a basis adjustment is foreign property left from a foreign person

to a U.S. person—that property in the hands of the U.S. person has a basis equal to the date of death value even though it was not in the decedent's gross estate for U.S. estate tax purposes. Rev. Rul. 84-139; PLR 201245006.) The Blattmachr, Gans & Jacobson article reasons "a good argument can be made that assets held in such a trust should be viewed as passing as a bequest or devise when the trust ceases to be a grantor trust at the moment of death." Up until the grantor's death, the assets have been treated as being owned by the grantor for income tax purposes.

The IRS has added to its "no-ruling" list that it will not issue rulings as to "[w]hether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code." Rev. Proc. 2015-37; *see* Diane Freda, *IRS No-Rule on Basis in Grantor Trust Sales Reflects Clash of Opinions*, BNA Daily Tax Report (June 19, 2015) (noting that tax attorney Alan Lederman observes that there are conflicting private rulings; PLR 201245006 concludes that a basis step-up would be available for the grantor trust assets at the grantor's death but CCA 200937028 reasons that "since the decedent transferred the property into the trust," there is no basis step-up under §1014). Jonathan Blattmachr's reaction to the no-ruling position is that the IRS "doesn't like the result of stepped up basis, and isn't going to assist taxpayers in reducing their tax bill—even if it is legitimate." *Id*.

(2) *Closing Letters Will Be Issued Only on Request*. In a June 16, 2015 update to the "Frequently Asked Questions on Estate Taxes" on the IRS website, the IRS indicates that for all estate tax returns filed on or after June 1, 2015, estate tax closing letters will be issued only upon request by the taxpayer. Taxpayers are asked to wait at least four months after filing the estate tax return to make the closing letter request "to allow time for processing." Apparently, this changed procedure is made in light of budgets cuts to the IRS and in light the fact that a closing letter does little good for returns filed solely to elect portability (because the statute of limitations on that return does not lapse until the statute of limitations lapses on the surviving spouse's return). Estates that owe estate taxes will almost routinely want to request the closing letter before making estate distributions.

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

At the ABA Tax/Real Property Probate and Trust Law Section Joint Meeting on September 18, 2015 Cathy Hughes (with the Treasury Department Office of Tax Policy) suggested that an alternative to requesting a closing letter is to request a transcript for the estate tax return. A particular code on the transcript indicates that the examination is complete (and a closing letter historically would have been issued). At some point, the regulations may state affirmatively that the transcript is the equivalent of a closing letter. The Frequently Asked Questions website at IRS.gov will be updated in the near future with this information.

3. Overview of Estate Planning Practices in the Current Environment

a. **Stability of Estate Transfer Tax Laws**. The American Taxpayer Relief Act of 2012 ("ATRA") provides for permanent provisions in the transfer tax area, without any further phase-ins. That stability did not exist from 2001-2012.

b. **Small Percentage of Population Subject to Transfer Taxes**. Estimates are that with a $5 million indexed gift and estate exemption ($5.43 million in 2015) only 0.14% of Americans who die each year will owe any federal estate tax (or about 2 out of every 1,000 people who die). The $5 million indexed gift exemption also means that many individuals have no concern with lifetime gifts ever resulting in the payment of federal gift taxes. There are still wealthy clients, though, and the wealthy are getting wealthier. (The Dow Jones average increased 26½% in 2013 and 7½% in 2014.)

c. **Cannot Ignore GST Tax**. Even low to moderate-wealth individuals cannot ignore the GST tax. Without proper allocation of the GST exemption (also $5 million indexed), trusts created by clients generally will be subject to the GST tax at the death of the beneficiary. (Sometimes that will occur by automatic allocation, but the planner must be sure that proper GST exemption allocation is made to long-term trusts even though the purpose of the trusts is not to save transfer taxes.)

d. **Fear of Estate Tax Uncertainty Is No Longer Driving Clients to Estate Planners**. Prior to 2012, Congressional action (or inaction) was driving clients to estate planning practices to make changes to estate plans. That is no longer happening. Estate planning practitioners will need to be more proactive in communicating with clients the importance of estate planning matters.

e. **Increased Relative Importance of Income Tax Issues**. At a time when the estate and gift tax for many Americans is zero, income tax planning is more significant than transfer tax planning. Even for couples with about $11 million of assets, little or no federal estate taxes may be due at the surviving spouse's death. Achieving basis step-up at each of the spouse's deaths may be very important. The ordinary income tax rate

(39.6%) is about the same as the federal estate tax rate (40%). Even the capital gains rate (23.8% including the 3.8% tax on net investment income), when combined with state income taxes, may approach the federal estate tax rate.

f. **Routinely Using Traditional Credit Shelter Trust/Marital Deduction Planning is Out Other Than For Very Wealthy Clients**. The days of automatically using traditional credit shelter trust/marital deduction planning for all clients with assets more than one exemption amount are gone. Some planners believe that planning for the $10 million estate is *more* difficult than planning for the $100 million estate, because of the balancing required between various alternatives, depending on future events, for the $10 million estate. There may be situations in which credit shelter trust planning is appropriate for the $10 million and under estates, but only with careful consideration of a wide variety of factors.

g. **Portability Approach Has Become More Predominant**. Unless strong reasons exist to use credit shelter trusts in $10 million and under estates, an approach of using portability to take advantage of the first spouse's estate exemption will become more predominant. The surviving spouse has both spouses' exemptions to cover estate taxes, but a basis step-up is achieved at both spouses' deaths. Some of the factors for favoring the creation of a credit shelter trust at the first spouse's death include if there

is (i) a likelihood or significant possibility of substantial appreciation of estate assets after the first spouse's death, (ii) a state estate tax, (iii) a blended family situation, (iv) a younger client scenario (in which remarriage of the surviving spouse is likely), (v) a situation in which the couple wants to use trusts after the first spouse's death and wants to have both the surviving spouse and descendants as discretionary beneficiaries of the trust.

Some planners refer to this as the "do no harm" approach. A fairly good tax plan is in place for couples with estates under $10 million before the client comes to the planner's office—no estate tax would likely occur at either spouse's death (although future appreciation may conceivably result in some estate taxes at the second spouse's death) and there is a basis step-up at both spouses' deaths.

h. **Planning Is More Difficult for Planners**. Tax simplification measures that permit additional planning alternatives, often make planning more difficult for planners, because the planner must review the appropriateness of each possible alternative. That has certainly happened with portability. Many attorneys report that discussing the portability alternatives with clients and the various factors impacting the decision often takes 20-30 minutes or more, and at the end of the discussion the client is often totally perplexed about what to do. Even after a decision is made, the planner must document the discussion, including the factors that were considered and the reason that the client made the decision that was made.

   Twenty years later, facts may occur that mean that an alternative course of action would have been preferable, and the planner needs to be able to document that the client made an informed, reasoned decision.

i. **Transfer Planning Still Important for Wealthy Families.** Transfer planning is still important for clients who will be subject to estate taxes (individuals with assets over about $5.5 million and couples with assets over about $11 million). An initial step is to focus on strategies that use no gift exemption or that leverage the use of gift exemption (therefore, leaving the client with estate exemption so that the client can own low basis assets at death, covered by the exemption, to achieve a basis step-up for those assets). Low-interest loans, GRATs, leveraged GRATs, and sales to grantor trusts (see paragraph k below) are all strategies that may accomplish those goals. GST planning is very important; with appropriate planning a large portion of even very large estates can be left in a GST exempt manner. See paragraph k and Item 4.e below. Special more sophisticated transfer planning strategies may also address ways to minimize the effect of losing basis adjustments at the transferor's death. See Items 5 and 7 below.

   Discounts for interests in partnerships and LLCs may at some point be diminished. The rumored §2704 regulations are making their way up the bureaucratic approval process. *Transfer planning with these interests might be accelerated*; the issuance of those proposed regulations may still take years, but it could happen sometime this year.

   In the unlikely event that the GRAT proposal in the 2016 Fiscal Year Plan Greenbook should pass, new GRATs would effectively be eliminated. (The remainder interest would have to be valued at the greater of 25% of the value contributed or $500,000, but not to exceed the value contributed, and the grantor could not purchase assets

from the GRAT. The proposal would apply to GRATs created after the date of enactment.)

j. **Be Very Careful Before Making Lifetime Gifts of Low Basis Assets**. Estate tax savings result from gifts by excluding the future appreciation in the donated assets from the donor's gross estate. The estate tax savings are offset by the loss of a basis step-up if the client dies no longer owning the donated property. For example, a gift of a $1 million asset with a zero basis would have to appreciate to approximately $2,470,000 (to a value that is 247% of the current value) in order for the estate tax savings on the future appreciation ($1,469,135 x 40%) to start to offset the loss of basis step-up ((2,469,135 x 23.8% for high bracket taxpayers). The required appreciation will be even more if there are also state income taxes on the capital gains.

k. **Grantor Trust Planning Still Advantageous**. Grantor trust planning continues to be very desirable for clients with large estates who are interested in transfer planning strategies to reduce estate taxes. See Item 7.b below. Even for more modest estates, grantor trusts afford substantial flexibility. Advantages of using grantor trusts include:

> (i) the grantor pays the income taxes on the trust income so the trust can grow faster and the tax payments further reduce the grantor 's taxable estate (studies have shown that this is the most important factor in the long-term effectiveness of transfer planning strategies—even more important than discount or freeze planning aspects of transfer planning strategies);
>
> (ii) the grantor can sell additional assets to the trust in return for a low-interest note without gain recognition on the sale (and all of the appreciation can be in a GST exempt trust if GST exemption is allocated to the initial gift to the trust); and
>
> (iii) the grantor has the flexibility to purchase back trust assets, in case the grantor prefers having assets that were transferred to the trust or if the grantor wants to reacquire low basis assets so they will receive a basis step-up at the grantor's death (the purchase should be made with cash or high basis assets because the income tax effects of purchasing low basis assets in return for a note are not certain). See Item 7.b below.

Examples of the flexibilities of grantor trusts are that the grantor can keep the ability to end the grantor trust status when desired and distributions can be made to the grantor's spouse to pay the income taxes if desired (assuming the spouse is a discretionary beneficiary).

Analytical studies of the financial impact of various strategies demonstrate that sales to grantor trusts can be incredibly efficient in accomplishing wealth transfer, particularly accomplishing wealth transfer in a many that is largely GST exempt. (See Item 4.e below.) In several recent cases, the IRS has taken that position that §2036 applies to sales to grantor trust transactions. Planners should take careful steps to create the best defense around a §2036 argument. (See Item 8.b below.)

l. **Undoing Prior Planning Strategies**. A number of clients will want to engage in planning to "undo" the effects of prior planning transactions if the client will not face estate taxes with the larger exemptions and does not want to lose the basis step-up at each spouse's death. This includes avoiding the funding of bypass trusts under the wills of clients who die without updating their wills, causing previously transferred low-basis assets to be included back in the donor's gross estate, and undoing prior discount planning.

m. **Basis Adjustment Planning**. Planning to leave open the flexibility to cause trust assets to be included in the gross estate of a trust beneficiary if the beneficiary has excess

estate exemption, to permit a basis adjustment at the beneficiary's death without generating any added estate tax, is increasingly important. Possible strategies include planning for the flexibility to make distributions to the beneficiary (either pursuant to a wide discretionary distribution standard or under the exercise of a non-fiduciary limited power of appointment), to have someone grant of general power of appointment to the beneficiary, to use of a formula general power of appointment, or to trigger the Delaware tax trap (by the exercise of a limited power of appointment to appoint the assets into a trust of which a beneficiary has a presently exercisable general power of appointment). See Item5 for a more detailed discussion of these strategies. Perhaps this type of planning is given a boost by the statement in President Obama's tax proposal that the "trust loophole" under §1014 is "perhaps the largest single loophole in the entire individual income tax code."

n. **Trust Planning**. Planning to use trusts will continue to be important, if for no other reason, for the non-tax advantages of trusts (including planning for long-term management and creditor protection or "divorce" protection for beneficiaries). However, these advantages must be balanced against the greater administrative and income tax costs for trusts. Trust structuring should incorporate planning for flexibility provisions to react to future conditions. Powers of appointment are becoming increasingly popular for various reasons in facilitating future flexibility.

o. **Estate and Trust Distribution Planning.** Estates and trust reach the maximum income tax bracket at only $12,300 in 2015; if distributions are made that "carry out" income to the beneficiaries instead, they may be in much lower brackets. (For example, married individuals do not reach the top bracket until they have taxable income in 2015 of $464,850.) This planning is particularly important for capital gains; trusts with income taxable income over $12,300 are taxed on capital gains at 23.8% (not counting any state income taxes). Individuals may have a 15% or even lower rate on capital gains. Increasing attention is devoted to causing capital gains to be in distributable net income (DNI) so that distributions can result in capital gains being subject to the15% or even lower rates. Ways of causing capital gains to be in DNI are described in Reg. §1.643(a)-3(b). An example clause giving the trustee discretion to utilize the flexibilities afforded by the regulation to cause capital gains to be in DNI is as follows:

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

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

This does not mean that trust distributions should automatically be made to reduce the trust's taxable income below $12,300. That may frustrate the reasons the trust was created. But trustees may need to consider income tax planning in making decisions of what is in the best overall interest of the trust and beneficiaries in accordance with the distribution standard in the trust instrument. Trusts with business income will focus on whether they can satisfy the material participation requirements

so that the resulting non-passive business income is not subject to the 3.8% tax on net investment income.

p. **State Estate Taxes**. Clients in states with state estate taxes will continue to need tax planning to minimize state estate taxes, which can be very significant. Twenty-one states and the District of Columbia have state estate taxes. New York's experience may be followed in other states (relaxation of the state exemptions but estate inclusion for gifts within three of deaths).

4. Portability and Financial Impact of Portability Decisions

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

Temporary regulations were released on June 15, 2012 (§§ 20.2010-1T, 20.2010-2T, and 20.2010-3T). Those regulations expired within three years (i.e., on June 15, 2015), and the IRS issued final regulations, effective June 12, 2015. The final regulations made relatively few revisions from the temporary regulations. Highlights of some of the more important provisions of the regulations include:

- The portability election is made by the executor's filing a timely and complete Form 706 (if the estate tax return is not timely filed and if the estate is small enough that no return would otherwise be required, Rev. Proc. 2014-18 allowed a relief procedure for certain estates through December 31, 2014, and the IRS in the preamble stated that the IRS is considering whether to make these types of extensions permanent, as discussed below);
- In most cases there will be no need to list values of assets passing to a surviving spouse or charity on the "timely and complete" Form 706 if the estate was not otherwise required to file an estate tax return (but the return must include an estimate of the total value of the gross estate within specified ranges, including assets passing to a spouse or charity);
- The surviving spouse's DSUE amount is not subject to being reduced if Congress later reduces the basic exclusion amount;
- The regulations adopt the "Example 3" approach of the Joint Committee Technical Explanation, negating any "privity" requirement in calculating the DSUE amount (an approach adopted legislatively by ATRA);
- If the decedent made gifts requiring the payment of gift tax, the excess taxable gift over the gift exemption amount (on which gift tax was paid) is not considered in calculating the DSUE amount;

- The surviving spouse can use the DSUE amount any time after the decedent's death, assuming the portability election is eventually made by the executor;
- Any gifts made by the surviving spouse are first covered by the DSUE amount, leaving the spouse's own exclusion amount to cover later transfers;
- DSUE amounts from multiple spouses may be used to the extent that gifts are made to utilize the DSUE amount from a particular spouse before the next spouse dies; and
- If the estate leaves assets to a QDOT, the surviving spouse cannot use the DSUE amount until the QDOT is fully distributed (or terminates at the surviving spouse's death).

The automatic extension of time for certain estates under the filing threshold to make the portability election announced in Rev. Proc. 2014-18 expired on December 31, 2014, but the preamble to the final regulations states that "[t]he Treasury Department and the IRS continue to receive, and are continuing to consider, requests for permanent extensions of this type of relief. However, such relief is not included in the final regulations."

The preamble to the final regulations also clarifies that a complete and properly prepared return that does not compute the DSUE amount because there is no unused exclusion based on the return as filed will be deemed to have satisfied the requirements for making the portability election if subsequent adjustments result in unused exclusion amount, without the need for making a "protective" portability election.

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

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

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

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

Planners must discuss the portability concepts and various factors impacting the decision of whether to rely on portability rather than using credit shelter trusts with clients and document those discussions. While the portability concept is intended to simplify planning, it has not made life simpler from the planner's standpoint.

c. **Major Factors.** Unless the couple owns assets close to double the exemption amount and still have significant growth years ahead, the couple will likely not owe any federal estate tax, whether the credit shelter approach or portability approach is used. For these clients, the major issues are:

- Use a credit shelter trust up to the state exclusion amount (if the state has an estate tax and if the state does not recognize portability [Delaware and Hawaii (and Maryland beginning in 2019) do recognize portability for their state estate taxes]);
- Leave qualified retirement plan and IRA benefits outright to surviving spouses (to take advantage of the longer-term payout opportunities afforded to spouses);
- Trust vs. no trust planning (*i.e.*, are the non-tax advantages of trusts important to the client—but trust planning can be used either with credit shelter trust or with portability and QTIP trusts);
- Blended family concerns—this is one reason to use the credit shelter trust to avoid complexities that might otherwise apply if conditions change such that estate taxes are owing at the surviving spouse's subsequent death (in which event the QTIP trust may end up substantially "underpaying" or "overpaying" the estate taxes and using a credit shelter trust would avoid that complexity);
- If trusts will be used, is it important for both the surviving spouse and descendants to be discretionary beneficiaries after the first spouse's death? (if so, use credit shelter planning unless the clients live in a "self-settled trust state" in which the surviving spouse could create a trust for himself/herself and the descendants without opening the trust to the spouse's creditor's claims—assuming domestic asset protection trusts work);
- Remarriage possibility—a significant possible disadvantage (especially for younger clients) is that the surviving spouse may remarry and the new spouse may die before the surviving spouse, resulting in a loss of the DSUE amount from the first deceased spouse (unless the surviving spouse made a gift utilizing that DSUE amount before the new spouse predeceased the surviving spouse);
- Asset protection significance—assets that are protected from creditor claims under state law (such as retirement accounts, homestead property and life insurance) can be left in those forms to maintain the asset protected status of the assets;

- Basis issues—the second basis step up is a major advantage of the portability approach (but ways of obtaining basis step up even with credit shelter trust planning may be possible); and
- State estate and income tax impact—If there is no state estate tax for the surviving spouse and a high state income tax for the children, portability may be favored; if there is a state estate tax for the surviving spouse and no state income tax for the children, the credit shelter trust may be favored; the results may be different for particular children depending on whether they are living in a high income tax state or not (some children may prefer the CST-at least up to the state exemption amount- and some may prefer portability).

For clients with estates substantially larger than the double the exemption amount, traditional creditor shelter trust planning is still appropriate.

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

d. **Should the Portability Election be Mandated? Who Pays the Filing Expense?** This is particularly important for second or (or third) marriages. If clients are asked if the surviving spouse should be able to use any excess exclusion, most will say yes. If clients are asked whether the surviving spouse should have to pay the first-decedent's family to be able to use the unused exclusion amount, most will say no. The planner may discuss with the clients whether the spouse of the decedent's estate should bear the expense of filing the estate tax return to make the election.

David Handler (Chicago, Illinois) indicates that he typically mandates in wills that the portability election will be made following the first spouse's death. Professor Stanley Johanson (University of Texas School of Law) suggests the following clause:

> If my husband survives me and my husband or his representative requests that my executor make a portability election with respect to all or a portion of my "deceased spousal unused exclusion amount," I direct my executor to make the election in the amount and under the terms provided to my executor by my husband or his representative. The cost of preparing and filing a Form 706 federal estate tax return making the portability election shall be [charged against my estate as an administration expense] [borne and paid for by my husband].

Similarly, consider these issues in pre-marital agreements.

Walton v. Estate of Swisher, 3 N.E.3d 1088 (Ind. App. 2014) is an example of negotiations that may arise regarding the portability decision if the decedent's will does not address the portability election. In that case the surviving husband agreed with the decedent's daughter to pay some of the deceased wife's medical expenses and to pay her estate $5,000. The husband died the following year. When the daughter learned of the estate tax savings that resulted from the use of the wife's unused exclusion amount, she sued his estate for $500,000 under an unjust enrichment theory. The court concluded that no additional amount was owed, and the

original agreement with the daughter was unambiguous and did not result in unjust enrichment.

The fact that this claim was even made raises interesting issues for planners:

- The importance of covering the filing/ portability issue in the couple's estate planning documents or marital agreement, including who pays for the cost of filing the return if it will be filed just to make the portability election;
- The possibility of opening a probate estate for the purpose of having an executor who can negotiate for the preparation of an estate tax return;
- Whether the surviving spouse is the appropriate person to serve as executor;
- The value of the right to file the estate tax return and make the portability election and whether the executor should negotiate to receive payment for making the election (a surviving spouse's counter argument is that the spouse may claim the available family allowance or spousal allowance that may be available to the spouse under applicable state law if the portability election is not made; the spousal allowance may be relatively small [e.g., $25,000 in Indiana] or can be fairly large [e.g., amount needed for the spouse's and minor children's maintenance for one year without regard to other resources available for the spouse's support in Texas, TEX. ESTATES CODE §353.102]); and
- The importance of the surviving spouse disclosing the potential benefits of portability when negotiating a payment for filing the return.

e. **Financial Impact**. At the 1025 Heckerling Institute on Estate Planning, Diana Zeydel (Miami, Florida) drew various conclusions from financial modeling (using a "Monte Carlo analysis" to take into consideration the volatility of possible outcomes) of likely outcomes with a diversified portfolio.

- A key element of any planning is to give the clients assurance that sufficient assets will be available for their lifestyle needs for life. Financial modeling can examine the effects of planning strategies if there are "down" markets in the future. Realize that for everyone, cutting back on lifestyle is extremely difficult, whether someone is used to living on $50,000 per year or $2 million per year.
- Surviving spouses typically have an "overlife" of 10 years of more. That is long enough for assets to have substantial appreciation and making the right choice can have a significant financial impact on the family.
- The financial impact to a family of doing planning vs. no planning and the effects among various different strategies is not nearly as dramatic as before ATRA—because of the large indexed exemptions.
- The credit shelter trust vs. portability decision can vary greatly depending on the state estate tax on the spouses and the state income tax that applies to the children. If there is no state estate tax for the surviving spouse and a high state income tax for the children, portability may be favored. If there is a state estate tax for the surviving spouse and no state income tax for the children, the credit shelter trust may be favored.

- For a couple with $10 million that spends 4% annually, leaving assets outright to the surviving spouse or in a QTIP trust and relying on portability will likely result in no estate tax being payable at the surviving spouse's subsequent death (the median result is that the assets will decline to about $9 million). However, there is no certainty of this. In 5% of the cases, the assets could grow to $18-20 million. Using a QTIP trust to make use of the first spouse's GST exemption means that most of the couple's assets would likely end up in GST exempt trusts.
- For a couple with $30 million (or more), the likelihood of achieving significant estate tax savings by using a credit shelter trust rather than relying on portability is very high, even if the spending level is 5%.
- For the couple with $30 million (or more), even greater amounts (and significantly more GST exempt amounts) could be transferred to descendants following the surviving spouse's death by using a "Supercharged Credit Shelter Trust[SM]". (This is because the credit shelter trust created for the surviving spouse is a grantor trust as to the surviving spouse, meaning that the trust can accumulate assets much more efficiently during the surviving spouse's lifetime and that the income tax payments will reduce the spouse's assets that are subject to estate tax.) For an even better result, the surviving spouse could make a gift to a grantor trust using his or her own exemption amount as well as taking steps to use the decedent's exemption amount (by a gift of the DSUE amount from the decedent or by using the Supercharged Credit Shelter Trust[SM] approach).

  A key result of using these approaches is that substantially more of the wealth passes to descendants in a GST exempt nature. As a practical matter, the portion of the estate that is non-exempt will likely be consumed by the children-generation (as discussed below).
- For clients with a diversified portfolio with typical turnover for a diversified portfolio, whether or not a basis step-up is available at the second spouse's death is not overly significant. (Gains are realized significantly during the surviving spouse's lifetime, and there is not a great deal of unrealized appreciation that would lose the benefit of a basis step-up.)
- The modeling shows that sales to grantor trusts are substantially more effective in transferring wealth than GRATs (as expected).
- For very large estates, doing "garden variety" sales to grantor trust planning can achieve huge transfer tax benefits—and a substantial part of the benefit is that much more of the estate will pass to the family in GST exempt trusts. For example, with a $100 million estate, if the spouses each currently make gifts of their $5.43 gift exemption amounts to GST exempt grantor trusts and annually make gifts of the additional indexed exemption amounts, and if W sells $48.9 million of assets to her grantor trust (9 to 1 debt to equity ratio), with reasonable assumptions on consumption rates, approximately 85-90% of the estate will be in GST exempt trusts at the second spouse's death assuming H dies in 5 years and W dies in 20 years. (Probably all of the estate, even for very large estates would pass for grandchildren in GST exempt trusts because the children will likely consume much if not all of the assets from the non-exempt trusts that are left

after the deaths of both spouses. Children will want to live in the same lifestyle as their parents, and if there are multiple children, the assets get divided too much to really permit that—leaving the conclusion that children will likely consume most or all of the non-exempt trusts.)

5. Basis Adjustment Flexibility Planning

a. **Consider Importance In Each Particular Situation**. In many situations, clients will have no federal estate tax concerns, and a key tax planning item will be to take advantage of the basis adjustment under §1014 that occurs at the client's death (that generally applies to assets owned by the client at death, but it can apply even more broadly than that, as discussed in Item 6.e below.) This can apply to assets that a client owns or to assets in a trust of which a client is a beneficiary. For some clients, this will be a key part of the tax planning to take advantage of what President Obama's tax proposal called "perhaps the largest single loophole in the entire individual income tax code."

   In other cases, however, basis adjustments will not be particularly important. For example, if an individual has a diversified managed investment portfolio, traditional turnover in the portfolio will mean that gains realized through the years, and there will not be a great deal of unrealized gain from appreciation in the portfolio. In those cases, basis adjustment planning will not be a priority. The discussion below applies to situations in which basis adjustment planning is determined to be important in a particular client situation.

b. **Consider Using Zeroed Out Transfer Planning.** Consider using transfer planning strategies that minimize the use of the client's gift and estate tax exemption amounts. Leaving estate tax exemption available allows the client to retain appreciated assets until death to receive the benefit of a basis step-up under §1014. For example, consider using GRATs (or "leveraged GRATs") to transfer future appreciation without using any of a client's exemption amount, or making leveraged use of estate and GST exemptions with gifts and much larger sales to grantor trusts. Various transfer planning strategies that may make very efficient use of exemptions amounts are discussed in Item 7.c below.

c. **Consider Using Third Parties' Exemption Amounts for Basis Adjustments.** A client may give/sell assets to a grantor trust for a third party (such as a modest-wealth parent of the client) who will have a testamentary general power of appointment in the trust. At the parent's death, the inclusion of the assets in his or her estate may generate no estate taxes but the assets would receive a basis adjustment (although issues could arise if the parent dies within a year of when the client creates the trust) and the parent could allocate his or her GST exemption to the assets. The assets might pass by default into a trust for the client's benefit but that would not be in the client's estate for estate tax purposes. Melissa Willms (Houston) has referred to the planning as the creation of the "Accidentally Perfect Grantor Trust," with this example:

   > Jenny owns the stock in a closely held business that she thinks is about to explode in value. Her mom Mary's net worth is perhaps $10,000. Jenny recapitalizes the company so that it has 1 voting share and 999 non-voting shares. She then sets up an IDGT for Mary's benefit, and sells the non-voting stock to the trust for its current appraised value of $1 million. She uses a combination of seed money and a guarantee by Mary to make sure that the sale is respected for tax purposes. The trust has language that grants Mary a general testamentary power to appoint the trust property to anyone she chooses. Mary signs a new will that leaves the trust property to a dynasty trust for Jenny and her descendants, naming Jenny as the trustee. (Just in case, the IDGT contains the same type

> of dynasty trust to receive the property if Mary fails to exercise her power of appointment.) When Mary dies four years later, the stock has appreciated to $2 million in value. Because the trust assets are included in Mary's estate, the stock gets a new cost basis of $2 million. The trust assets, when added to Mary's other assets, are well below the estate tax exemption of $5 million. Mary's executor uses some of Mary's $5 million GST exemption to shelter the trust assets from estate tax when Jenny dies. Despite the fact that Jenny has the lifetime use of the trust property, (i) it can't be attached by her creditors, (ii) it can pass to Jenny's children, or whomever Jenny wishes to leave it to, without estate tax, (iii) principal from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants without gift tax, and (iv) if the trust isn't a grantor trust as to Jenny, income from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants, thereby providing the ability to shift the trust's income to taxpayers in low income tax brackets.

Mickey R. Davis and Melissa J. Willms, *Trust and Estate Planning in a High-Exemption World and the 3.8% 'Medicare' Tax: What Estate and Trust Professionals Need to Know*, UNIV. OF TEXAS SCHOOL OF LAW 61ST ANNUAL TAX CONFERENCE (December 2013).

Gift Tax Issues. The trust is a gift by the client, using the client's gift exemption. But the sale to the trust and the payment of income taxes by the grantor may leverage the appreciation of assets in the trust, making use of the client's gift exemption advantageous.

Estate Tax Issues–Parent's Estate. The trust assets contributed to the trust will be included in the parent's gross estate under §2041. The assets that are sold to the trust may also be included in the parent's gross estate, although issues can arise as to whether merely the *net* value of those assets (i.e., net of the debt that the trust owes to the client) is included in the estate. *See Reg.* §20.2053-7 ("if the decedent's estate is not so liable [for the amount of the mortgage or indebtedness], only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need by returned as part of the value of the gross estate"). Having the parent guarantee the trust indebtedness would create a stronger argument for including the full value of the trust assets in the parent's gross estate (to receive a basis adjustment for the assets). The client anticipates that the parent will have plenty of estate exemption so that the parent will pay no estate tax. (If the client thinks that the trust assets may grow to the point that the assets exceeds the parent's estate exemption, the trust could include a formula general power of appointment for the parent, to the extent that inclusion of the trust assets in the parent's estate would not cause the parent's gross estate to exceed the exemption amount. If that is done, the trust would also have to provide that only assets subject to the general power of appointment would remain in trust for the benefit of the client.)

Estate Tax Issues–Client's Estate. The parent will be treated as the transferor of the trust after his or her death, so the client can be the trustee, a discretionary beneficiary (as long as the client cannot make distributions to himself beyond amounts needed for health, education, support and maintenance), and can have a testamentary limited power of appointment over the trust—all without causing inclusion in the client's gross estate—as long as the client's state has passed legislation providing that the client is not treated as the settlor of the trust for creditor purposes (i.e., overriding the traditional "relation back" doctrine—see Item 15.d of the Hot Topics and Current Developments Summary (December 2013) found here and available at www.Bessemer.com/Advisor for a detailed discussion of the "relation back" issue). A variety of rulings involving "joint spousal trusts" have made this clear. PLRs 200604028, 200403094, 200210051, 200101021. *See* John Bergner, *Waste Not*

Want Not—Creative Use of General Powers of Appointment to Fund Tax-Advantaged Trusts, 41st Annual Heckerling Inst. on Est. Pl. ch. 14 (2007).

Income Tax—Grantor Trust. The client will likely create the trust as a grantor trust as to the client. Following the parent's death, there is a strong argument that the trust continues as a grantor trust as to the client under Reg. §1.671-2(e)(5) if the parent does not exercise the general power of appointment. *See generally* M. Gans, J. Blattmachr, & D. Zeydel, *Supercharged Credit Shelter Trust℠,* 21 PROBATE & PROPERTY 52, 55 (July/August 2007). If the parent exercises the general power of appointment, the deemed grantor of the trust changes for purposes of the grantor trust rules, and the trust would no longer be a grantor trust as to the client. *See* Mickey Davis, *Basis Adjustment Planning*, 2014 STATE BAR OF TEX. ADV. EST. PL. & PROB. COURSE ch.10 at 21 (2014).

Income Tax—Basis. The assets should receive a basis adjustment at the parent's death because the assets are included in the parent's gross estate (but see the discussion above about the estate tax consequences for the parent as to whether only the net value of trust assets are included in the estate). Mickey Davis points out that if the testamentary general power of appointment is not exercised by the parent, the basis adjustment arises under §1014(b)(9) instead of §1014(b)(4). Section 1014(b)(9) (but none of the other 1014 subsections) limits the basis adjustment for depreciation taken by a taxpayer other than the decedent prior to the decedent's death. Because the "accidentally perfect trust" is usually designed to be a grantor trust, the junior family member is presumably "the taxpayer" for this purpose. The §1014(b)(9) limitation would appear to apply to any depreciation deductions taken by the junior family member prior to the death of the senior family member. As a result, if the trust remains a grantor trust as to the junior family member after the senior family member's death, the amount of the basis adjustment might be reduced by the amount of the depreciation deductions allowed to the junior family member prior to the senior family member's death. See Treas. Reg. § 1.1014-6.

If the parent dies within a year of when the client makes the gift to the trust and if the assets pass back to the client, §1014(e) would prevent a basis adjustment. If the assets merely pass to or remain in a trust of which the client is a discretionary beneficiary (or may be added as a discretionary beneficiary by a third person after some point in time), §1014(e) may not apply.

GST Tax Issues. The client could allocate GST exemption to the trust, but alternatively, the client might allocate no GST exemption initially and allow the parent to allocate his or her GST exemption at the parent's death. The parent will be treated as the transferor to the trust for GST tax purposes. §2652(a)(1)(A); Reg. §26.2652-1(a)(1).

Creditor Issues. Under the laws of some states, assets that pass to a trust for the client (either by the exercise of a general power of appointment or upon the unexercised lapse of a general power of appointment) will generally be protected from claims of the client's creditors. *E.g.,* TEX. PROP. CODE §112.035(g)(3)(B) (trust spendthrift protection applies to irrevocable trust for the benefit of the settlor "to the extent that the property of the trust was subject to a general power of appointment in another person").

Practical Uses. Having a "permanent" $5 million indexed estate tax exclusion amount makes this type of planning realistic; the client can feel very comfortable that the parent will not have estate tax concerns even with the general power of appointment over the trust assets.

Similarly, a beneficiary of a trust who has a limited power of appointment might appoint the assets to a trust in which a third party (such as a modest-wealth parent) has a testamentary general power of appointment. The assets would receive a basis adjustment at the parent's death, hopefully no estate taxes would be payable by the parent, and the parent could allocate his or her GST exemption to the assets.

d. **Preserving Basis Adjustment Upon Death of Donor/Settlor.** For a detailed discussion of basis adjustment planning for donors, see Item 10 of the Hot Topics and Current Developments Summary (December 2013) found here and available at www.Bessemer.com/Advisor. Various strategies for causing inclusion of assets in the settlor's estate to achieve basis adjustments at the settlor's death are summarized in Item 1.e. above.

e. **GST Impact.** Basis adjustment planning considerations for trusts is important particularly for GST-exempt trusts. For non-exempt trusts, if a taxable termination occurs at a beneficiary's death (for example, when the last non-skip person dies), a GST tax is imposed and a basis adjustment is allowed. §2654(a)(2).

f. **Causing Inclusion of Assets in a Trust Beneficiary's Estate**. If a beneficiary has substantial excess estate exemption, causing inclusion in the beneficiary's estate (up to the beneficiary's excess estate exemption) may afford a basis adjustment at the beneficiary's death without resulting in any federal estate taxes. For example, if a credit shelter trust is used at the first spouse's death and the surviving spouse has excess estate exemption amount, these strategies could be used to cause some or all of the credit shelter trust assets to be in the surviving spouse's gross estate to achieve a basis adjustment at his or her subsequent death. The same strategies could apply to any other beneficiary of a trust who has excess estate exemption. Strategies that may be considered for these purposes are briefly summarized below. Each of these strategies is addressed in considerably more detail Item 7.c-g of the Hot Topics and Current Developments Summary (December 2014) found here and available at www.Bessemer.com/Advisor.

Distributions to Beneficiary. There are fiduciary concerns as to whether the distribution (especially a large distribution made primarily to achieve a basis adjustment at the beneficiary's death) can be justified within the standard for distributions. If a trustee makes distributions beyond what is authorized in the instrument, the IRS may take the position that it can ignore the distribution. *See Estate of Lillian L. Halpern v. Commissioner*, T.C. Memo. 1995-352.

Exercise of Limited Power of Appointment. Another possible way of addressing the potential reluctance of exercising broad distribution powers because of fiduciary concerns is to grant someone a non-fiduciary power of appointment to appoint trust assets to the beneficiary. However, gift tax concerns with the exercise of such a power of appointment may arise if the powerholder is a beneficiary of the trust. *See* Treas. Reg. §§25.2514-1(b)(2), 25.2514-3(e) Ex.3; PLRs 9451049, 8535020.

Independent Party With Power to Grant General Power of Appointment. The trust agreement could give an independent party the power to grant a general power of appointment to the beneficiary. It could be a power exercisable only with the consent of a non-adverse party if the settlor wishes to place some controls over the beneficiary's unbridled ability to redirect where the assets will pass. The power could be limited to the ability to appoint the assets to the beneficiary's creditors. Preferably this power would be held by someone other than the trustee. Because of the trustee's fiduciary duty to all beneficiaries, a trustee may be reluctant to grant any particular beneficiary a general power of appointment except in special circumstances (for example if the beneficiary was the only beneficiary and held a broad testamentary limited power of appointment in any event). Perhaps provide that the independent party cannot grant a general power until requested to consider exercising its discretion (to avoid a continuing duty to monitor). One planner's approach is to include a general power for beneficiaries but give the trustee or some other party the power to remove the general power. Query whether a beneficiary may be deemed to have a general power of appointment for tax purposes even before it is actually granted?

Formula General Power of Appointment. To avoid the risk that the third party never "gets around" to granting the general power of appointment, consider granting it by formula in the trust from the outset under a formula approach. The formula could start by giving the beneficiary a general power of appointment up to the amount that would not generate estate taxes in the beneficiary's estate, and could further detail by formula which trust assets would be subject to the general power of appointment.

A very simple formula approach, if the beneficiary clearly does not have to pay estate taxes even considering the trust assets, is to give the beneficiary a testamentary general power of appointment over non-IRD appreciated property. (Only non-IRD appreciated property benefits from a basis adjustment under §1014.) Another very simple formula approach would be to grant the general power of appointment over a fractional share, the numerator of which fraction is "the largest amount which, if added to the beneficiary's taxable estate, will not result in or increase the federal estate tax payable by reason of the beneficiary's death."

Issues may be raised as to whether the limitations under this type of "conditional" general power of appointment would be recognized for tax purposes (so that the beneficiary would not automatically have a general power of appointment over all of the trust assets). However, *Kurz v. Commissioner*, 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995) reasoned that if a decedent's general power of appointment was contingent on the occurrence of certain events, the decedent could have some control over the contingency and still not have a general power of appointment, but the contingency must not be "illusory" and must have independent significant non-tax consequences. If the formula grants a general power of appointment up to the amount of the beneficiary's remaining exemption amount less the value of the beneficiary's taxable estate, the beneficiary has a great deal of control to increase the amount subject to the general power of appointment by reducing the size of his taxable estate—for example by consuming assets, by making terrible investment decisions, or by leaving assets to a spouse or charity—which would increase the amount of the formula general power of appointment. However, those would all seem to be acts of independent significance. The risk of such an argument could be minimized

> by drafting the formula clause granting a general power of appointment based on the surviving spouse's taxable estate, determined without regard to marital or charitable deductible transfers. This approach significantly reduces the likelihood that a court would conclude that the surviving spouse holds a general power of appointment over a greater share of the trust assets than his or her available applicable exclusion amount. If it is known that the surviving spouse will make certain charitable bequests, these can be expressly excluded from the calculation, with the same result.

HOWARD ZARITSKY, PRACTICAL ESTATE PLANNING IN 2011 AND 2012.

The formula could also specify which assets are subject to the general power of appointment (and therefore would be entitled to a basis adjustment at the beneficiary's death). Perhaps a trustee or other third party could have the authority to determine which assets are subject to the general power (but would that be recognized for tax purposes?). Alternatively, the formula could specify objectively which particular assets are subject to the general power of appointment formula amount. The formula might allocate the general power first to the assets that if sold immediately prior the beneficiary's death would generate the greatest aggregate amount of federal and state income tax, or it might be customized to apply first to low-basis assets that are the most likely to be sold after the beneficiary's death. Be wary of using a formula that is so complicated to apply that substantial expense would be incurred in applying the formula. For a discussion of general considerations in crafting a formula general power of appointment, see Leonard & Schingler, *Using a "Formula General Power of Apportionment* [sic] *to Resolve Income Tax Basis "Step-Up" Issues in the Age of Portability and a Request for Clarification Regarding Revenue Procedure 2001-38*, CALIF. TAX LAWYER, at 24-32 (Fall 2014). For a much more detailed discussion of the validity of such formula general powers of appointments, with references to various articles discussing them in detail with sample forms, and for examples of formula general powers of appointment see Item 5.e and Exhibits A and B of the Hot Topics and Current Developments Summary (December 2014) found here and available at www.Bessemer.com/Advisor.

Delaware Tax Trap. The beneficiary who would like to have the asset included in his gross estate, to achieve a basis step-up at the beneficiary's death, could exercise a limited power of appointment that he has under the trust by appointing the assets to another trust in which some person has a withdrawal right or other presently exercisable general power of appointment. That may trigger §2041(a)(3) to cause the assets to be included in the beneficiary's gross estate. (In addition, the trust assets so appointed would be in the other person's gross estate as well, but that person may have modest wealth so that no estate tax would be owed at that person's death.)

Generally, all that must be done to leave open the flexibility of using the Delaware tax trap is for the trust to give the beneficiary a limited power of appointment that includes the power to grant new presently exercisable powers of appointment (the power to appoint in further trust would generally include this authority) and confirm that the perpetuities savings clause is worded in terms of requiring that the interests of beneficiaries must "vest" within the prescribed perpetuities time frame rather than requiring that they be *distributed* during that time frame. Arizona has changed its state law (and other states are considering similar changes) so that the Delaware tax trap could be triggered by a beneficiary (to cause the beneficiary to include the assets in his or her estate under §2041) by merely exercising a power of appointment in a

manner that gives another person a *nongeneral* power of appointment. For a further discussion of the complexities of the Delaware tax trap, see Item 7.f of the Hot Topics and Current Developments Summary (December 2014) found here and available at www.Bessemer.com/Advisor.

Asset Protection Impact. Distributing assets to a beneficiary obviously subjects the assets to the creditors of that beneficiary. The law is unclear (and developing) as to whether merely granting a general power of appointment to a beneficiary subjects the assets to the claims of that beneficiary's creditors. (It does under the position of the Restatement (Third) of Property, which position has been adopted in various states, including California, Michigan and New York.) A possible solution is to require the consent of a third person (who would need to be a nonadverse party in order of the power of appointment to cause estate inclusion under §2041).

6. Basis Background

In light of the increased importance of income tax issues and basis issues in particular, Howard Zaritsky (Rapidan, Virginia) and Lester Law (Naples, Florida) discussed a wide range of fundamental issues regarding basis matters at the 2015 Heckerling Institute on Estate Planning.

a. **Significance and General Description.** Basis is a taxpayer's investment in property. It impacts a variety of tax issues including depreciation and the amount of gain realization upon the sale or exchange of an asset. An asset's initial basis or original basis is its cost (sometimes referred to as "cost basis"). Adjustments can be made to the initial basis for a variety of things including additions to basis for capital improvements and capitalized expenditures, and reductions to basis for depreciation and depletion.

   Basis is especially important for wealthy people—they may not have much ordinary income but will have a lot of capital gains. A taxpayer's basis in assets often dictates financial decisions. "It is hard to convince clients to pay a capital gains tax that they don't absolutely have to pay today."

b. **Brief History**. After ratification of the 16th amendment, the Revenue Act of 1916 introduced the concept of basis. For assets acquired before March 1, 1913, basis was equal to value on that date. Regulations added that for assets acquired after that date the basis or property was its cost and this was codified in the Revenue Act of 1918.

   Gifts and Bequests. The Revenue Act of 1921 provided a transferred basis approach for gifts and bequests. The Revenue Act of 1928 changed this to a date of death value basis rule for bequests. That was changed various times during the years 1928-1934, ending up with the date of death approach for bequests.

   Carryover Basis. The major modification to the basis rules, for estate planning and administration purposes, was the adoption of a carryover basis approach in 1976 (quickly repealed) and the one year experiment allowing an elected carryover basis instead of estate tax in 2010.

c. **Carrying Charges.** A little used rule is that carrying charges (such as real estate taxes or mortgage interest), may be capitalized and added to basis rather than being deducted in a particular year. §266. This can be helpful if the taxpayer does not have

income to be offset by a deduction in a particular year. However, the election to capitalize carrying charges to be added to basis must be made on the return for the year; it cannot be elected on an amended return.

d. **Property Acquired by Gift**. Basis transfers on the date the donor relinquishes dominion and control over property, not necessarily the day on which title passes. For appreciated property, the donee's basis is equal to the donor's basis increased by gift tax paid on the appreciation (but not to exceed the asset's fair market value) at the time of the gift. (The gift tax attributable to the appreciation can be added to basis regardless of whether the donor or donee pays the gift tax.) The rule is different for depreciated property, to prevent low-bracket donors from transferring their losses to high-bracket donees. For depreciated property (i.e., the fair market value is less than the adjusted basis of the property), the donee's basis is the donor's basis for purposes of determining the amount of gain on a later sale but is the lower fair market value of the property on the date of the gift for purposes of determining the amount of loss on a later sale. (The Code does not specifically address a sale that is made at a price between the FMV at the date of the gift and the adjusted basis, but there is neither gain nor loss recognized in that event.)

   Gift Tax Returns. The gift tax return has a column to list the basis of donated property. That column is often left blank, but the return preparers should include the basis information to keep track of the basis for the donor and donee. Indeed, some planners report that on occasion the IRS has returned gift tax returns that do not have the basis column completed.

   Giving Depreciated Property Is Discouraged. These basis rules discourage gifts of depreciated property (perhaps other than if the depreciation arises because of discounts of partnership interests). A preferable approach is for the taxpayer to sell the property to recognize the loss and give the proceeds. Furthermore, there is no adjustment in the basis for gift tax paid when giving depreciated property because only gift tax attributable to appreciation can be added to basis.

   Danger of Giving Highly Appreciated Property. The estate tax savings that result from excluding future appreciation in the donor's gross estate are offset by the loss of a basis step up. Appreciated property with a zero basis would have to appreciate to about 247% of its date of gift value before the estate tax savings (at a 40% rate) on the appreciation that is removed from the estate would start to outweigh the capital gains cost (at a 28% rate) of not getting a stepped up basis at the donor's death (if the donor had kept the property) when the property is ultimately sold. See Item 3.j above and Item 7.a below.

e. **Property Acquired From a Decedent**. Howard Zaritsky (who I have always assumed knew everything—and I'm still sure that he knows just about everything) indicated he was surprised in preparing this information how different the text of §1014 is compared to what he thought the rules were. While §1014 provides for a basis adjustment to the date of death value for property included in a decedent's gross estate, there are various other situations in which property that is "acquired from a decedent" will receive a basis adjustment, detailed in nine subsections of §1014(b). (Section 1014(b)(9) is the "included in the decedent's gross estate" section, but other subsections are far more general, including subsection (b)(1) which simply refers to

"property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." An example of an asset not in a decedent's gross estate for estate tax purposes that receives a basis adjustment is foreign property left from a foreign person to a U.S. person—that property in the hands of the U.S. person has a basis equal to the date of death value even though it was not in the decedent's gross estate for U.S. estate tax purposes. Rev. Rul. 84-139; PLR 201245006.)

If any property that was transferred during life is still included in the decedent's gross estate (the regulations use the example of gifts in contemplation of death because the regulations are old) and the property is depreciable, the depreciation deductions taken by the transferee are subtracted from the date of death value basis. (Howard Zaritsky commented: "That had never crossed my mind. Fortunately, it had not crossed my desk.")

For community property, the community property interest of the surviving spouse as well as the community property interest of the decedent gets a basis adjustment. §1014(b)(6).

f. **Generation Skipping Transfer Tax**. Property transferred from a non-exempt trust in a taxable termination that occurs at the same time as, and as a result of, the death of an individual receives a basis adjustment in the same manner as provided in §1014 (i.e., the value of the property on the date of the transfer). If the trust is partially exempt from the GST tax, the basis adjustment is limited to the adjustment times the inclusion ratio. For a taxable distribution or direct skip or taxable termination occurring other than at and by reason of the death of an individual, the basis is increased, but not above fair market value, by the portion of the GST tax attributable to appreciation in the value of the transferred asset immediately before the transfer. (A special rule in §2612(a)(2) characterizes distributions to skip persons that occur on the death of a lineal descendant of the transferor as a taxable termination; therefore the basis adjustment would be permitted except to the extent that GST exemption is allocated to the direct skip resulting in an inclusion ratio of less than one.)

g. **Holding Period.** An asset's holding period determines whether a gain or loss will be long-term or short-term. A holding period of more than one year results in long-term gains/losses. §1222(3)-(4). The holding period for getting long term capital gain treatment is really a year and a day. If an asset is bought on January 1 and sold on January 1 of the following year, that is not a long-term holding period. (Whether or not the year is a leap year makes no difference for this purpose.)

Tacking. An individual's holding period generally starts upon acquiring the asset. In some transactions, the new owner's holding period includes the holding period of the prior owner (called "tacking").

For gifts, tacking applies if the new owner's basis is determined in whole or in part by the donor's basis. §1223(2). Therefore, tacking applies to gifts of appreciated property (because the donee's basis is the same as the donor's basis). For gifts of depreciated property, if there is a subsequent sale at a gain, tacking applies (because the basis is the donor's basis in that event), but if there is a subsequent sale at a loss there is no tacking (because the donee's basis is the fair market value of the property at the date of the gift and is not determined by the donor's basis in the property).

For a part gift, part sale transaction, the holding period of the portion that is a deemed sale starts on the date of the sale; for the gift portion, the tacking rules for gifts (described in the preceding paragraph) will control.

For property acquired from a decedent, the general rule is that the inherited property receives long-term gain or loss treatment. Section 1223(9) and (10) provide that even if the property is sold within a year, the property will be deemed to have been held for more than one year. However, for this deemed one-year rule to apply, the person who sells the property must be the person who received the property from the decedent. If the recipient of a bequest gives the property to a donee who later sells it within a year, the deemed one-year holding period rule does not apply and the sale will generate a short term capital gain/loss. (For decedents who died in 2010 and made the election for carryover basis to apply under §1022, the automatic one-year holding period rule does not apply, but the decedent's holding period generally becomes the beneficiary's holding period. *See* Rev. Proc. 2011-41.)

h. **Uniform Basis Rules**. Property acquired from a donor or decedent has a single or uniform basis, even if multiple persons acquire an interest in the property. Reg. §§1.1014-1(b), 1.1015-1(b). For example, this would apply if the property is left in a life estate or trust. The basis of the property is apportioned among the various beneficiaries based on the values of their interests in the life estate/remainder or in the trust. For interests subject to a life estate or mandatory income interest, the value of the income interest is based on the person's age and the §7520 rate. Therefore, the proportionate values of the beneficiaries' interests change from month to month. There are no clear rules as to how to value interests of beneficiaries under ascertainable standards or of discretionary beneficiaries.

The uniform basis rules are particularly important in two situations: (1) for depreciation deduction allocations (and the way that accountants allocate the deductions in that case is often wrong); and (2) when a beneficiary sells his or her interest in the trust. If a term interest is sold, the seller is deemed to have a basis of zero unless it is sold in a transaction in which *all* interests in the trust are sold to a third party. (For example, if the holder of the annuity interest in a CRAT sells his annuity interest, the seller's basis is zero and all of the proceeds are gain.)

The IRS deems the commutation of a trust, in which the term and remainder interest holders receive their proportionate shares of the underlying assets, as a sale of each beneficiary's interest and the seller of the term interest gets no basis. The IRS will not rule on a commutation of a CRT. Rev. Proc. 2015-3. On the other hand, if the trust is terminated by selling both the term and remainder interests to a *third person*, the seller of the term interest can apply his or her basis to determine gain.

i. **Proving Basis.** This is another aspect of determining basis that is somewhat surprising. If the donee of a gift does not have facts to determine the basis in the hands of the donor, §1015(a) requires the IRS "if possible" to obtain the information from the donor or anyone else who may know the facts. If finding the facts becomes impossible, the basis shall be the fair market value of the property as of the date or approximate date that the donor had acquired the property. Reg. §1.1015-1(a)(3). Various cases have allowed approximating the basis. *Cohan v. Commissioner*, 39 F.2d 540 (2nd Cir. 1930) is cited as stating a "close is good enough" rule. The Sixth Circuit in the

Caldwell v. Commissioner case (234 F.2d 660) indicates that if there is some evidence to prove basis, the IRS cannot ignore it and must make an effort to determine the basis. (In that case, the court determined that there was sufficient evidence to find the fair market value of the stock around the time that the donor [or the last prior owner] acquired the property.)

j. **Part Gift/Part Sale Transaction**. In a *non-charitable* part gift/part sale, the transaction is treated as a sale to the extent the consideration received exceeds the transferor's adjusted basis. Reg. §1.1001-1(e). The transferor's basis is allocated entirely to the sale portion of the transaction (which is very taxpayer friendly—reducing the gain that the seller recognizes.) The transferee's basis is the greater of the consideration paid or the transferor's adjusted basis at the time of the transfer plus any gift taxes paid. Reg. §1.1015-4.

   For a *charitable* part gift/part sale, in which all or part of the gift portion is deductible as a charitable deduction under §170, the transferor's adjusted basis is allocated between the sale and gift portions—which increases the gain that is recognized by the seller as compared to the noncharitable part gift/part sale situation.

k. **Sales to Grantor Trusts**. *Revenue Ruling 85-13*. The fundamental underpinning of the sale to grantor trust concept is Rev. Rul. 85-13, which ruled that the grantor is the deemed owner of the grantor trust assets for income tax purposes (so the grantor trust did not get a new cost basis in the asset that it acquired from the grantor for a promissory note). While this conclusion may be questionable, there have now been five other published revenue rulings, two notices, and over 125 private letter rulings, chief counsel advisories, field service advice and technical advice memoranda supporting this same position. Even so, this sobering thought puts the underlying rationale of this favorable treatment of grantor trusts in perspective:

   > The fountainhead of modern grantor trust law is Rev. Rul. 85-13. Nevertheless, lest it be thought that the technique addressed in this article is iron-clad, it is good for one's perspective to be reminded from time to time that the most serious authority in this area is an IRS ruling that defies the holding of a respected U.S. Court of Appeals.

   Ronald Aucutt, *Installment Sales to Grantor Trusts*, 2 BUS. ENTITIES 28 (April/May 2002).

   Basis Adjustment for Gift Tax Paid. Is a basis adjustment for gift tax paid allowed if there was no gift for income tax purposes because the grantor is deemed to still own the property? PLR 9109027 says there is a basis adjustment for gift tax paid but only when the grantor trust status terminates. (But that does not help if the asset is sold before the grantor trust status terminates.) Howard Zaritsky believes there should be a basis adjustment for gift tax paid, but acknowledges that neither he nor the IRS have any real authority for their respective positions. Howard believes accountants typically report gifts to grantor trusts by making the basis adjustment for gift tax paid.

   Trust's Basis in Note from Grantor. Howard believes that the note the grantor receives from the grantor trust in a sale transaction has no basis. If the note and the property transferred to the trust both have a basis equal to the grantor's basis in the property prior to the sale, there would be double counting of the basis.

   Termination of Grantor Trust Status During Grantor's Lifetime—Effect on Gain Recognition and Basis. Termination of grantor trust status during the grantor's lifetime

can result in recognition of gain and, logically, the increase in the basis of assets held by the then-nongrantor trust. *See* Rev. Rul. 77-402, 1977-2 C.B. 222; Reg. §1.1001-2(c)Ex. 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985).

Termination of Grantor Trust Status at Grantor's Death—Effect on Gain Recognition and Basis. There is no answer on which everyone agrees. The IRS has not expressed a precedential position. Under Rev. Rul. 85-13, the grantor is the deemed owner of the grantor trust's assets for income tax purposes. The death of an individual is not itself a recognition event. Testamentary transfers of encumbered assets do not themselves result in recognition of gain, so the grantor's death should be treated for income tax purposes as if the grantor owned the encumbered assets and disposed of them by traditional testamentary transfer at death. Howard believes strongly the answer should be that no gain is recognized on death.

What about the basis of the assets in the trust? For income tax purposes the grantor owned the property on the date of death, not the trust. The trust becomes the owner upon the grantor's death. There is a "not bad" argument that the deemed change of ownership for income tax purposes at the grantor's death constitutes the receipt of property from a decedent for purposes of §1014, and that there should be a basis step up even though the assets are not included in the gross estate. *See* Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. TAX'N 149 (Sept. 2002). "BUT good luck getting an accountant to take that position on an income tax return." Howard would be willing to take that position on a return, advising the client that the IRS will fight the issue if it spots the issue. He believes there is no risk of penalties for taking that position because it is not contrary to any existing law and is supported by some law. CCA 200923024 draws a distinction between the effects of a grantor trust status terminating during the grantor's lifetime and of a lapse of grantor trust status "caused by the death of the owner which is generally not treated as an income tax event." *But see* CCA 200937028 (questioning whether basis adjustment is allowed under §1014 for assets transferred to grantor trust if assets are not in decedent's gross estate). A response to that CCA is that foreign property left from a foreign person to a U.S. person receives a basis step-up even though the assets in not in the decedent's gross estate for U.S. estate tax purposes. Rev. Rul. 84-139; PLR 201245006.

I. **Private Annuities.** The basis of the purchaser in a sale of assets for a private annuity varies at different times and for different purposes. Rev. Rul. 55-119, 1955-1 C.B. 352; Rev. Rul. 72-81, 1972-1 C.B. 98.

During Annuitant's Lifetime. For computing depreciation on the property purchased, or for calculating gain if the annuitant resells the property *while the annuitant is still alive*, the basis is the present value of the annuity agreement on the date of the sale. (If the purchaser makes annuity payments in excess of that amount, the additional payments may be added to basis for these purposes.) If the property is sold at a loss during the annuitant's lifetime, the basis is the amount of payments actually made. If the sale is for more than the payments made but less than the present value of the annuity at the time of the sale, neither gain nor loss is recognized.

Following Annuitant's Death. At the annuitant's death, basis is adjusted down to the amount (if less) that has in fact been paid less any depreciation deductions allowable with respect to the annuity property.

m. **Self-Canceling Installment Note**. *Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993) adopted the IRS position that the portion of the note that is canceled at death is recognized as gain by the estate as IRD under §691(a)(5)(iii). That is consistent with the IRS position discussed in GCM 35903. A strong five-judge dissent in the Tax Court opinion (98 T.C. 341) authored by Judge Halpern took the position that there was no cancellation of indebtedness income, because that indebtedness never existed—the SCIN was negotiated with the understanding that no payments were due after the seller's death. (Judge Halpern included sample language to avoid the result reached by the majority in *Frane.* He suggested that every payment be subject to the precondition that the transferor is alive—and he offered sample language to accomplish that result.)

   If assets are sold to a grantor trust for a SCIN, the arguments regarding sales to grantor trusts discussed above would be applicable at the grantor's death.

n. **Special Use Valuation**. If property is valued for estate tax purposes under §2032A, and if there is subsequently a recapture tax that must be paid if the qualified use of the property ends within ten years of the decedent's death, the qualified heir can elect (in an irrevocable election) to increase the basis of the property by the amount of the estate tax value reduction allowed under §2032A, *but* the heir would have to pay interest on the recapture tax, running from the original estate tax return due date to the date the recapture tax is paid. §1016(c)(5)(B).

o. **Life Insurance**. The income tax effects of sales or surrenders of life insurance policies were recently addressed in Rev. Ruls. 2009-13 and 2009-14. The IRS position is that the basis of a life insurance policy is generally the total premiums paid reduced by the "cost of insurance protection" provided throughout the policy's existence and further reduced by nontaxable dividends the insured has received. Rev. Rul. 70-38; ILS 200504001.

7. Transfer Planning Strategies Considering Both Income and Estate Tax Savings

a. **Danger of Giving Highly Appreciated Property**. The estate tax savings that result from excluding future appreciation in the donor's gross estate are offset by the loss of a basis step up. Appreciated property with a zero basis would have to appreciate to about 247% of its date of gift value before the estate tax savings (at a 40% rate) on the appreciation that is removed from the estate would start to outweigh the capital gains cost (at a 28% rate) of not getting a stepped up basis at the donor's death (if the donor had kept the property) when the property is ultimately sold. See Item 3.j above.

   To determine the growth rate required to overcome the loss of the basis adjustment at death, one planner suggests the following formula:

   (Capital Gain Rate x (Gift Value - Basis]) + (Gift Tax Rate x [Gift Value – Remaining Gift Tax Exemption]) – (Estate Tax Rate x [Gift Value – Estate Tax Exemption at Death])

Value of Gift x (Estate Tax Rate – Capital Gains Rate)

Formula by Kelly Hellmuth (McGuire Woods) as reported by Stacy Eastland (Houston, Texas).

There may be various reasons why the loss of basis step-up is not particularly important. Investment considerations for many individuals may suggest the wisdom of selling particular assets classes and investing in other classes to maintain a diversified portfolio—meaning that the low basis assets will likely be sold in any event during the donor's lifetime. On the opposite end of the planning spectrum, the assets may be family assets that will likely be held in the family long after the grantor's death with an anticipated long delay in any capital gains income tax cost. (Beware though: A client may be adamant that a particular asset will never be sold, but the heirs secretly cannot wait to sell it.) If the assets are held in the family until the death of the next generation, a basis step-up may be available at that time; in any event, the income tax cost upon selling the asset may be long in the future.

b. **Grantor Trusts.** "The grantor trust is the leveraged plan of choice, leaving substantial flexibility." There are three significant advantages of using grantor trusts.

- *Income Tax Payments.* The grantor pays the income taxes attributable to the trust income so the trust assets can grow faster (and the tax payments further deplete the grantor's assets that would otherwise be subject to estate taxes).
- *Grantor Sales to Trust*. The grantor can sell assets to the trust without causing realization of income. Rev. Rul. 85-13. There should be no gain realization even if the note is not paid by the time of the grantor's death (although there is some uncertainty about this matter). See Item 6.k above.
- *Flexibility for Repurchases*. There is substantial flexibility in the planning, because the grantor can repurchase low-basis assets from the grantor trust. The grantor could purchase the assets by exercising a swap power or, if there is no swap power, by a negotiated sale. The purchase could be made with a high interest rate note from the grantor to achieve more wealth transfer. The best approach would be to pay off the note before the grantor's death because the trust may have a low (or zero) basis in that note. The grantor may need to borrow funds from a third party lender to be able to pay off the note to the grantor trust. This could be prearranged so that the borrowing and payment could be accomplished very quickly if the grantor determines that death is imminent. If the grantor's estate does not have sufficient cash to repay the third party lender (and does not want to sell the assets that the grantor purchased from the trust), the grantor trust could purchase the receivable from the bank so that the grantor's estate would owe the payment to the trust (which it might satisfy with the asset that received a basis adjustment at the grantor's death).

Another way of using grantor trusts is for a trust beneficiary to sell S corporation stock to a trust for which the QSST election trust beneficiary. Alternatively, to avoid having a high amount of unrealized appreciation, for which there is no basis step-up at the grantor's death because the trust assets are not owned by the grantor, consider

adjusting the asset allocation of the trust. Some passive equity investments have more current income and less unrealized appreciation than others.

c. **Strategies to Save Exemption to Preserve Exemption for Basis Step-Up; Leveraged GRAT**. Various strategies can transfer wealth without using gift exemption, or by leveraging the gift exemption. This approach can leave the client with estate exemption at death, so that low basis assets could be owned until death to receive a basis step-up. These strategies include GRATs and cascading sales to grantor trusts. Using defined value clauses can assist in minimizing the use of gift exemption.

A leveraged GRAT can be quite efficient. This strategy introduces leverage into a GRAT transaction, so that it has the leveraging characteristics of sale to grantor trust transactions. A simple straightforward method of introducing leverage would be for the GRAT to borrow as much as possible and invest the borrowed proceeds in assets with appreciation potential. There would be the increased possibility of "hitting a home run" but also a greater risk that the GRAT would implode and that the GRAT would be "underwater." Although that transaction might have a greater likelihood of transferring significant value from the GRAT, it also has high economic risks for the family.

Another way to introduce leverage is to use an existing family investment entity, and leverage that vehicle within the family (but not introducing the added economic risk to the family of outside leverage), so that the *net equity value* contributed to the GRAT is substantially lower, resulting in much lower annuity payments that hopefully can be satisfied out of cash flow if the GRAT has a long enough term.

For example, assume client owns an interest in an FLP with financial/private equity assets.

(1) The client might contribute 10% of the LP units to a wholly owned LLC in return for units in the LLC, and sell 90% of the LP units to the LLC in return for a 9-year balloon note.

(2) The net equity value of the LLC would be represented by the value of the 10% contributed as a capital contribution. The value of the LLC would be based on the discounted value of the 10% LP units.

(3) The capital interest in the LLC (having a net value, without considering any discounts, equal to 10% of the value of the total LLC assets) would be contributed to a 10-year GRAT. Because of the discounted value of the LP units and because of the 9-to-1 leverage of the LLC and because of the ten-year term, the annuity payments may be low enough that the cash flow from the FLP (or other financial/private equity assets) to the LLC and from the LLC to the GRAT may be sufficient to pay the annuity payments in cash.

(4) At the end of the 10-year GRAT term, it would then own all of the capital interests in the LLC.

Sophisticated planners have used this strategy in various situations. It can work particularly well if the client wanted to transfer interests in a private equity fund. The client typically has both a "carry interest" and an "investment interest." The client would contribute both the carry and investment interest to a single member LLC (that

is a disregarded entity), partly as a capital contribution and partly as a sale for a note (9-to-1 ratio). Transferring both the carry and investment interests avoids the application of §2701. The capital interest in the LLC would be contributed to the GRAT.

This is somewhat comparable to a gift and sale to grantor trust transaction. The leveraged GRAT is better in that the client does not have to use up any significant amount of gift exemption. If the assets do not perform, nothing is transferred to family members via the GRAT, but there is also no wastage of gift exemption (which can occur under a sale to grantor trust transaction if the assets in the grantor trust decline below the amount of the note).

d. **Using Parent's Exemptions.** Many wealthy clients are self-made and have modest-wealth clients who they support. The client may give/sell assets to a grantor trust for the modest-wealth parent who will have a testamentary general power of appointment in the trust. At the parent's death, the inclusion of the assets in his or her estate may generate no estate taxes but the assets would receive a basis adjustment and the parent could allocate his or her GST exemption to the assets. See Item 5.c above.

e. **Transfer Planning With Parent Retaining Cash Flow for Living Expenses**. Clients may be unwilling to engage in transfer planning because they need to keep all of the cash flow they have currently for living expenses. Planners explain that they cannot make a gift and retain the income from the gift asset or else §2036 will apply. The following strategy allows the parent to keep the current cash flow—which both provides living expense to the parent and shifts the income tax burden to the parent rather than to family trusts to allow the trust to grow faster. Client and client's grantor trust contribute assets to a preferred partnership (or LLC). The client receives the preferred interest and the grantor trust receives the growth interest. (Perhaps the entity is initially a single member LLC owned entirely by the client [or perhaps it is an LP and the grantor trust only has a small interest], but the client later gives the growth interest to the grantor trust.) The preferred interest is structured to satisfy §2701. The preferred interest has a high coupon rate (perhaps 8-10%) that as a practical matter equals about all of the cash flow from the entity's assets. The client is able to make a transfer, shifting the growth interest to the grantor trust, while continuing to receive all of the cash flow from the assets.

f. **Planning Idea to Help Preserve Discount.** If a client is paying estate tax and wishes to minimize the likelihood of an IRS audit about discounts and if transfers have been made by only one spouse, consider having the grantor-spouse transfer enough assets to the other spouse so the grantor-spouse does not have to file an estate tax return. In that manner the grantor-spouse would not have to "check the box" that he or she made a transfer or sale of an interest in a partnership, limited liability company, or closely held corporation (Question 13e of Part 4 on the Form 706).

8. IRS's Radar Screen

a. **Kitchen Sink Approach.** There is a growing trend of the IRS to add every conceivable argument in the Notice of Deficiency—even though the arguments may not have been addressed in the course of the examination. In addition, there is a growing trend of the IRS alleging penalties seemingly routinely. (As an example, the recently pending

Williams case makes about all of the arguments against a family limited partnership that the IRS has raised over the last decade, but a stipulated decision was entered in that case on March 20, 2015 providing for a stipulated estate tax deficiency much less than the amount alleged by the IRS and not applying penalties. In *Woelbing*, the IRS is alleging that §2702 and 2036 apply to a note sale when it appears that the primary matter at issue is the valuation of property that was sold to a grantor trust. See Item 9 below.)

b. **Installment Sales to Grantor Trusts**. The IRS is closely examining sale to grantor trust transactions, from both a gift and estate tax standpoint.

- *Gift tax*. The major *gift tax* issue is the value of the property that is sold. That IRS may also question the value of the note (see Item 8.f below). Alternatively, the IRS may argue that the note is valued at zero for gift tax purposes under §2702 (or perhaps under §2701) or because it is not a bona fide transaction.
- *Valuation-Step transaction*. A valuation issue that arises is the *Pierre* step-transaction argument. *Pierre v. Commissioner* (T.C. Memo 2010-106) required that interests given and sold on the same day had to be aggregated for valuation purposes (but in that case, aggregating the gifted and sold limited partnership interests only decreased the discount from 38% to 35%) The sale should be made some time after the "seed gift." How long? John suggests 30 days should suffice, but 60 days is better, and the next tax year is better yet.
- *Estate tax*. The IRS sometimes also makes an estate tax argument—that §2036 applies and the assets that were sold should be brought back into the estate rather than including the remaining value of the note in the estate. Traditionally, the IRS has not argued that §2036 applies to sales to grantor trusts (and many sale transactions have been through audits without the IRS making that argument). However, the IRS made the §2036 argument in the pending *Woelbing* case (see Item 9 below), a case in which there may have been concerns about the amount of equity in the trust to support the sale since several of the decedent's sons gave personal guarantees for 10% of the purchase price. John Porter reports that he tried another case in December 2013 (*Estate of Beyer v. Commissioner*) in which the IRS also made the §2036 argument; the IRS argued that all of the assets of a family limited partnership are included in the estate under §2036 and it also argued that partnership interests that were sold to a grantor trust should also be brought back into the estate under §2036.
- *Step transaction issue regarding §2036*. The *Pierre* step transaction argument may come into play with the §2036 issue—if the IRS argues that the gift and sale should be treated as a single transaction so that the transfer for full consideration exception of §2036 could not possibly apply (though the IRS does not appear to have made that argument directly in any case.)
- *Planning regarding §2036*. To help in defending against a §2036 argument for sales to grantor trusts, John suggests (1) that the partnership distributions should not be made at the same time and in the same amounts as the note payments, and (2) separating the gift and sale so that the taxpayer can argue

that the sale transaction is for full and adequate consideration so that the full consideration exception to §2036 applies. John predicts that the IRS will not prevail in its §2036 or §2702 arguments in *Woelbing*.

Further planning ideas to avoid §2036 argument. Avoid the §2036 issue by having the grantor's spouse or another grantor trust loan funds to the trust that will purchase the assets from the grantor, so that note payments will not thereafter be made to the grantor/seller. *See Jo*nathan Blattmachr, *Protecting an Estate Tax Plan from Turner, Trombetta, Davidson, Woelbing, Etc.,* ANNUAL NOTRE DAME ESTATE PLANNING INST. (2014).

d. **Family Limited Partnerships and LLCs.** The most litigated issue is whet*her* assets contributed to *an FLP/LLC should be included in the estate under §2036 (without a discount reg*ARDING RESTRICTIONS APPLICABLE TO THE limited partnership interest). There have been about 37 reported cases. The IRS typically argues that assets should be included under §2036(a)(1) as a transfer to the FLP/LLC with an implied agreement of retained enjoyment. In a few cases, it has also made a §2036(a)(2) argument, that the decedent has enough control regarding the FLP/LLC to designate who could possess or enjoy the property contributed to the entity. The government wins about 2/3 of those cases. (In some of those cases, the FLP/LLC assets have been included in the estate under §2036 even though the decedent had transferred the partnership interests during life (*Harper, Korby*).)

Bona Fide Sale for Full Consideration Defense. Almost every one of these cases that the taxpayer has won was based on the bona fide sale for full consideration exception to §2036. (The two exceptions are *Kelly* and *Mirowski,* which held there was no retained enjoyment under §2036(a)(1) as to gifts of limited partnership interests.) The key is whether there were "legitimate and significant nontax reasons" for using the entity. There is nothing wrong with having tax reasons for creating entities, but the test is whether there was "A" legitimate and significant nontax reason as well. John Porter summarizes factors that have been recognized in particular situations as constituting such a legitimate nontax reason.

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

Section 2036(a)(1) Implied Agreement of Retained Enjoyment. Courts have considered the following factors in determining that there was an implied agreement of retained enjoyment (as summarized by John Porter).

- Non pro-rata distributions (*Harper, Korby, Thompson*)
- Personal expenditure with partnership funds (*Strangi, Hurford, Rector*)
- Personal use assets in partnership (*Strangi*)

- Payment of estate tax and expense when assets were transferred to the FLP/LLC close to death (*Miller, Strangi, Erickson, Jorgenson, Bigelow*)
- Accurate books and records not kept (*Harper*)
- Insufficient assets outside of FLP/LLC for living expenses (*Thompson, Miller, Strangi, Rector*)

Section 2036(a)(2). The §2036(a)(2) issue impacts whether the client can serve as the general partner of an FLP or manager of an LLC. There are three relevant cases, two of which held that §2036(a)(2) applied, but in unique fact situations. Traditionally, planners have relied on the *Byrum* Supreme Court case for the proposition that investment powers are not subject to §2036(a)(2).

In *Strangi* (T.C. Memo 2003-145), the decedent owned 47% of the stock of an S corporation that was the 1% general partner. The court held that the decedent, in conjunction with others, could designate who could enjoy or possess the FLP property. However, the decedent was the 99% limited partner, so the court could reason that any fiduciary duties owed as GP were not significant because there was no one with an interest to enforce those duties.

In *Turner II* (T.C. Memo 2011-209), the court acknowledged that a transferor's retention of the right to manage transferred assets does not necessarily require inclusion under §2036(a)(2), citing *Byrum* and *Schutt v. Commissioner.* However, the court gives no further analysis whatsoever of limits imposed by *Byrum.* One of the reasons given by the court for applying §2036(a)(2) was that the decedent effectively was the sole general partner. In addition, the court mentioned three powers that the general partner had, two which were the sole and absolute discretion to make pro rata distributions of partnership income (in addition to distributions to pay Federal and State tax liabilities) and the power to amend the partnership agreement at any time without the consent of the limited partners.

Estate of Cohen v. Commissioner (79 T.C. 1015) involved a decedent who was co-trustee of a Massachusetts business trust. The co-trustees had broad management powers including whether to declare dividends. The court observed the *Byrum* Supreme Court's emphasis on the fiduciary obligations that the decedent owed in that case to shareholders and concluded that §2036(a)(2) did not apply because the trustees of the business trust did not have unlimited authority regarding distributions but had to act within a fair standard of conduct made in good faith in the exercise of a bona fide business judgment. The court stated that if the trustees had unlimited discretion, "so that dividends could be arbitrarily and capriciously withheld or declared, then the dividend power would constitute a 'right' under section 2036(a)(2); if, on the other hand, the power is circumscribed by cognizable limits on the exercise of discretion, then no such 'right' exists."

If a client wants to serve as the GP of an FLP or manager of an LLC, John thinks that §2036(a)(2) could be avoided if a business judgment ascertainable standard is imposed on distributions. He recommends in that case that the entity agreement should mandate that distributions be made in accordance with that standard (including the ability to maintain reserves as determined in the exercise of his or her

fiduciary obligation and reasoned judgment to be necessary for future investments and expenses).

Other Issues--§2703 and Indirect Gift. Other issues that the IRS sometimes raise in audits regarding FLP/LLCs are (1) whether specific restrictions in partnership agreements should be ignored for tax purposes under §2703 (*Holman* and *Fisher II*)

and (2) whether contributions to an FLP/LLC immediately followed by gifts or interests in the entity should be treated as indirect gifts of the underlying assets of the entity (*Holman, Gross, Linton,* and *Heckerman*).

Chart of FLP/LLC Discounts. John Porter has prepared a helpful chart summarizing the discounts that have been recognized in cases involving FLP or LLC interests. The chart is attached as Appendix A.

In addition to the FLP/LLC cases listed in that chart, the recent *Estate of Richmond* case (T.C. Memo 2014-26) addressed discounts for the decedent's 23.44% interest in a C corporation investment holding company. It allowed a 7.75% lack of control discount, a 32.1% lack of marketability discount, and a built-in gains discount of about 43.16% of the tax liability if all of the assets in the corporation had been sold immediately at the date of the decedent's death.

e. **Formula Transfers With Defined Value Clauses**

(1) *Types of Defined Value Formula Approaches.* John Porter reports that he has had a lot of success over the last few years in upholding transfers made under defined value formulas. There are five basic types of these clauses:

- Formula allocation clause, allocating portions of a transferred asset between taxable and non-taxable transfers based on the subsequent agreement of the parties (*McCord, Hendrix*)
- Formula allocation clause, allocating portions of a transferred asset between taxable and non-taxable transfers based on values as finally determined for federal gift tax purposes (*Christiansen, Petter*)
- Clause defining the amount transferred based on values as finally determined for federal gift tax purposes (*Wandry*)
- Price adjustment clause (*King;* but *McLendon* and *Harwood* did not recognize price adjustment clauses)
- Reversions to donor of excess over a specified value (*Procter*)—this condition subsequent approach does NOT work. The clause in *Procter* provided that any amount transferred that was deemed to be subject to a gift tax was returned to the donor. It trifles with the judicial system, because any attempt to challenge the gift or raise gift tax defeats the gift. The *Procter* doctrine does not invalidate all formula transfers. Since the 1944 *Procter* case, many other types of formula clauses have been blessed by the IRS and the courts (marital deduction clauses, GST formula allocations, split interest charitable trust clauses, GRATs, formula disclaimers, etc.).

(2) *2015-2016 Treasury Priority Guidance Plan Project*. The 2015-2016 Priority Guidance Plan (sometimes referred to as the IRS's "Business Plan") adds the following item: "Guidance on the gift tax effect of defined value formula clauses under §2612 and 2511." See Item 2.a. above. Apparently, the IRS is adding a regulations project to address defined value formula clauses.

(3) *Recent Discussion of Procter in Belk*. *Procter* was recently discussed by the Fourth Circuit (the same circuit that decided *Procter)* in *Belk v. Commissioner*, 774 F.3d 221 (4th Cir. December 16, 2014). *Belk* was not a valuation case but involved a violation of one of the substantive requirements to obtain a conservation easement. The contribution agreement allowed substituting other land as long as that did not harm the conservation purpose. The IRS contended that violated one of the requirements for a conservation easement, that there be a restriction in perpetuity on specific real property. The contribution agreement included a "savings clause" providing that the charity (a land trust)

> shall have no right or power to agree to any amendments … that would result in this Conservation Easement failing to qualify … as a qualified conservation contribution under Section 170(h) of the Internal Revenue Code and applicable regulations.

The taxpayer argued that even if the substitution provision causes the contribution not to satisfy the statutory requirements for a deductible easement, "the savings clause nonetheless renders the Easement eligible for a deduction." The taxpayer acknowledged that the courts have rejected "condition subsequent" savings clauses that alter a gift following an adverse determination by the IRS or a court, but tried to distinguish *Procter* (without arguing that it was incorrectly decided), arguing that the substitution clause was not a "condition subsequent savings clause" but was merely an interpretive clause to make clear there could be no amendment inconsistent with the overriding conservation intention of the parties. The court disagreed with the attempt to apply this clause as a broad savings clause in this fashion:

> [In *Procter*] [w]e explained that the taxpayer's attempt to avoid tax, by providing the gift "shall be void" as to property later held "subject to the tax," was "clearly a condition subsequent," and involved the "sort of trifling with the judicial process [that] cannot be sustained." Id.
>
> So it is here. The Belks' Easement, by its terms, conveys an interest in real property to the Trust. The savings clause attempts to alter that interest in the future if the Easement should "fail[] to qualify as a … qualified conservation contribution under Section 170(h)."
>
> …
>
> If the Belks' "overriding intent[]" had been, as they suggest, merely for the Easement to qualify for a tax deduction under § 170(h), they would not have included a provision so clearly at odds with the language of § 170(h)(2)(C). In fact, the Easement reflects the Belks' "overriding intent[]" to create an easement that permitted substitution of the parcel -- in violation of 170(h)(2)(C) -- and to jettison the substitution provision only if it subsequently caused the donation to "fail[] to qualify … as a qualified conservation contribution under Section 170(h)." Thus, the Belks ask us to employ their savings clause not to "aid in determining [their] intent," Rev. Rul. 75-440, but to rewrite their Easement in response to our holding. This we will not do.
>
> Indeed, we note that were we to apply the savings clause as the Belks suggest, we would be providing an opinion sanctioning the very same "trifling with the judicial process" we condemned in *Procter*. 142 F.2d at 827. Moreover, providing such an opinion would dramatically hamper the Commissioner's enforcement power. If every taxpayer could rely on a

> savings clause to void, after the fact, a disqualifying deduction (or credit), enforcement of the Internal Revenue Code would grind to a halt.

While *Belk* is not relevant to valuation formulas and does not address the continuing validity of *Procter*, its discussion is interesting in the context of savings clauses generally. Ron Aucutt draws the following conclusions from *Belk:*

> [T]he issue in Belk was a substantive requirement of the conservation easement statute, not valuation….But meanwhile, Belk provides an occasion to reflect on the "savings clauses" that are routinely used in estate planning documents (and all kinds of other documents) apart from a valuation context. While each case will bring its own facts and attract its own analysis, Belk suggests that such clauses that are intended to protect against inadvertent or incidental violations of applicable requirements are fine. But they would not save a trust, for example, from such a violation that is part of the core structure of the trust. For example, the Belks' ability to shift their conservation easement from property to property appeared to be such a core element of their conservation easement arrangement – and such a flagrant violation of the "perpetuity" requirement of section 170(h)(2)(C) – that the savings clause could not save it.

Aucutt, *Recent Developments – 2014,* 49th ANNUAL HECKERLING INST. ON EST. PL. (2015).

(4) *Structuring Allocation Clauses*. Formula allocation clauses are supported by more judicial authority if the portion passing as a non-taxable transfer passes to charity. John's preferred defined value approach is using a formula allocation approach with the "excess" value passing to a public charity-donor advised fund. The public charity directors have independent fiduciary obligations, and the charity is subject to private inurement and excess benefit rules. (Private foundations create complex self dealing and excess business holdings issues.) Other possible "pour-over" non-taxable recipients could include QTIP trusts or GRATs. If a public charity is not used, John thinks the IRS argument is weakest if the GRAT is used, because the §2702 regulations support using an approach of defining the annuity amount based on the value contributed. (The IRS may argue that a GRAT results in assets passing back to the donor and invokes *Procter*.) If a QTIP trust or GRAT is used for the non-taxable portion of the transfer, John prefers that there be different trustees and somewhat different beneficial interests than the trust that receives the taxable portion of the transfer.

(5) *Compliance Best Practices.* The IRS will "nibble around the edges" of these clauses and try to find pitfalls to show that the clauses were not respected. If a clause is used that is based on values as finally determined for federal gift tax purposes, a federal gift tax return must be filed reporting the formula transfer, or else there will never be a final determination of the gift tax value. The transaction should be reported on the gift tax return consistent with the formula transfer, providing that all that was transferred is the amount determined by the formula, but the units are initially allocated based on values as reflected in an attached appraisal.

(6) *Wandry Clauses.* John has negotiated several favorable settlements with *Wandry* type clauses. He has a case under examination currently with a *Wandry*-type clause that is going to Appeals.

There were likely a number of *Wandry* transfers made in late 2012. Gift tax returns for many of them were likely filed in the late summer-early fall of 2013, and gift tax audits are beginning to emerge regarding those transfers.

Some commentators suggest that the issue more important than whether the *Wandry* clause is respected to determine the *amount* that is transferred, is whether the gift tax audit/case causes a final determination of the *extent* of property transferred. They suggest that there is a risk that years after the gift tax audit, the IRS might contend that the gift tax audit/case merely determines a gift tax deficiency and does not preclude the IRS from later claiming that the

donor/seller continued to be the owner of a larger fraction of the property. *See* Austin Bramwell & Brad Dillon, *Not Another* Wandry *Article: Real Issue With* Wandry *Formulas*, 41 EST. PLANNING (May 2014).

The IRS informally has indicated that it has not given up on its opposition to *Wandry*-type clauses and is still looking for "the right case."

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

(7) *Sample Price Adjustment Clause*. Ron Aucutt offers the following for consideration as a possible sample price adjustment clause:

> The face amount of the Note shall be the fair market value of the Interest on <Date> as determined by an appraisal by <Appraiser>. To the extent it is finally determined for federal gift tax purposes that the fair market value of the Interest on <Date> exceeds the fair market value determined by <Appraiser>, the face amount of the note shall be increased by an amount equal to 99.9997 percent of that excess, rounded down to the nearest whole dollar.

Ronald Aucutt, *Sales to Grantor Trusts (Best Practices in Light of Concerns Raised by Woelbing and Trombetta Cases)* (January 30, 2015). Ron observes that the clause will result in at least a minimal taxable gift if there is an adjustment.

(8) *Sample Defined Transfer Clause.* Ron Aucutt offers the following for consideration as a possible defined value clause that merely defines the amount of an interest that is transferred:

> I transfer that number of units in <Entity> that has a fair market value on the date of the transfer, as finally determined for federal gift tax purposes, of $<Appraised Value> plus 0.0003 percent of the amount, if any, rounded up to the nearest whole dollar, by which the fair market value of <Target Number> units in <Entity> on the date of the transfer, as finally determined for federal gift tax purposes, exceeds $<Appraised Value>.

Ronald Aucutt, *Sales to Grantor Trusts (Best Practices in Light of Concerns Raised by Woelbing and Trombetta Cases)* (January 30, 2015). (Ron is not suggesting any assurance that these clauses will be recognized by the IRS or the

courts, or even recommending that they be used, but he merely offers them for consideration by planners who are considering using a price adjustment approach or a defined value transfer approach.)

f. **Challenges of Promissory Notes.** The IRS challenges the value of promissory notes, either arguing that the AFR is not a sufficient interest rate, or that the collateral is not sufficient and there are collectability problems. The taxpayer response is that §7872, the *Frazee* case, and the *True* case support using the AFR, and John said the note valuation issue generally falls out at Appeals. (The IRS contested the valuation of a note in a Tax Court case, *Estate of Williams*, but a stipulated decision was entered on March 19, 2015 providing an estate tax deficiency much less than that requested by the IRS.)

Another argument made in some audits is that the note transaction is not a bona fide loan but is a gift. Cases list a variety of factors that are considered in determining whether debt is legitimate or not (in a variety of different contexts beyond just gift issues), but the fundamental issue is whether there was a reasonable expectation of repayment.

The IRS sometimes challenges note refinancings (to lower interest rates). John thinks the IRS position is very weak; notes are often renegotiated in commercial transactions. John has resolved several of these cases, and he has one case at Appeals currently regarding a note refinancing. **Clearly document any refinancing of an existing note to a lower interest rate. Recite the prepayment clause, that the debtor is willing to prepay, that the lender is willing to exchange a new note for the prior note, and recite the revised terms.**

The 2015-2016 Priority Guidance Plan (sometimes referred to as the IRS's "Business Plan") adds the following item: "Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872." See Item 2.a. above. Apparently, the IRS is adding a regulations project to address promissory note valuation issues. Regulations currently address the valuation of notes (Treas. Reg. §§ 25.2512-4 and 25.2512-4); presumably focus of the new regulations will be to address the valuation impact of using the AFR as the interest rate.

g. **GRATs.** There is significant audit activity of GRATs, typically to confirm that the terms of the GRAT are being satisfied and that the annuity payments are being made properly and timely. If not, the IRS makes an argument under *Atkins v. Commissioner* that the GRAT should be disqualified ab initio.

On occasion, the examining agents scour the trust instrument to confirm that all of the requirements of the GRAT regulations are included in the instrument.

If there have been substitution transactions with the GRAT, the examining agent closely reviews the values of property involved in the exchange. If hard-to-value assets have been used to make annuity payments, the IRS reviews that proper valuations have been used. John suggests using a *Wandry* formula transfer of hard-to-value assets that are used to satisfy annuity payments.

9. SALE TO GRANTOR TRUST TRANSACTION UNDER ATTACK, *ESTATE OF DONALD WOELBING V. COMMISSIONER* AND *ESTATE OF MARION WOELBING V. COMMISSIONER*

a. **Overview.** A very effective method of "freezing" an individual's estate for federal estate tax purposes is to convert the appreciating assets into a fixed-yield, non-appreciating asset through an installment sale to a family member. Selling the appreciating assets to a grantor trust avoids the recognition of income on the initial sales transaction and as interest and principal payments are made on the note (at least as to payments made during the grantor's lifetime). See Item 6.k above regarding income tax effects if the note is not paid during the grantor's life. The grantor's payment of the trust income taxes allows the trust to grow much faster (and depletes the grantor's estate that would otherwise be subject to estate tax). See Item 4.e above for a discussion of how incredibly successful these transactions can be in moving wealth in a GST exempt nature to the family.

   The IRS and Treasury have expressed their discomfort with sale to grantor trust transactions by making dramatic legislative proposals in the 2013 and 2014 Administration's Revenue Proposals (narrowed in the 2014 Proposal to target sale to grantor trust transactions specifically), as described in Item 1.d above.

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

   Estate and gift tax examiners on occasion have questioned whether sales for notes bearing interest at only the meager AFR should be recognized. (There are some indications that the *Karmazin* case [discussed below], which received a great deal of attention in 2003, initially arose because of the examiner's concern over use of the AFR as the interest rate on an intra-family sale transaction.)

b. **Woelbing Estates Cases.** The IRS is attacking sale to grantor trust transactions in two companion cases that were filed December 26, 2013 in the Tax Court. *Estate of Donald Woelbing v. Commissioner*, Docket No. 30261-13; *Estate of Marion Woelbing v. Commissioner*, Docket No. 30260-13. (These are pronounced "WELL-bing.")

   In 2006, Mr. Woelbing sold all of his non-voting stock in Carma Laboratories (a closely-held company located in Wisconsin) to a trust (presumably a grantor trust) in return for a promissory note having a face value of about $59 million, bearing interest at the AFR. The purchase price was determined by an independent appraiser. The note contained a defined value provision stating that if the value of the stock is later determined by the Internal Revenue Service or a court to be different than the appraised value, the number of shares purchased shall automatically adjust so that the fair market value of the stock purchased equals the face value of the note.

   The sale was made to an "Insurance Trust" that owned three life insurance policies on the lives of Mr. and Mrs. Woelbing. (The policies were subject to an "economic benefit

regime" Split-Dollar Insurance Agreement, under which the trust was obligated eventually repay Carma for its advances of premium payments.) Two Woelbing sons (who were beneficiaries of the trust) executed personal guarantees to the trust for 10% of the purchase price of the stock. The estate's position is that the trust-purchaser had substantial financial capability to repay the note even without considering the stock itself, and that this financial capability exceeded 10% of the face value of the promissory note. (It is not clear whether the 10% cushion included the personal guarantees or whether the trust's financial capabilities other than both the stock and the personal guarantees exceeded 10% of the note face amount.)

Mr. and Mrs. Woelbing filed gift tax returns for 2006, 2008 and 2009 making the split gift election; therefore, if the 2006 sale transaction had a gift element, the gift was treated as having been made one-half by each of the spouses for gift and GST tax purposes.

Mr. Woelbing died in July 2009 and Mrs. Woelbing died in September 2013 (interestingly, only two days after receiving the IRS's Notice of Deficiency for almost $32 million against Mrs. Woelbing for her gift tax). In the estate tax audit of Mr. Woelbing's estate, the gift tax returns for 2006 and several other years were also audited.

Gift Tax Issues. The IRS asserts that the note should be treated as having a zero value for gift tax purposes and is contesting the underlying value of the stock in 2006 (asserting a value in 2006 of $116.8 million compared to the $59 million purchase price). The IRS Notice of Deficiency asserts that for gift tax purposes, "Section 2702 requires inclusion of the entire value of nonvoting shares … as gifts when they were sold… in exchange for a note." Thus, the IRS position is that the note should be treated as having a zero value under §2702. Alternatively, if §2702 does not apply, the Notice of Deficiency alleges that "the donor made a taxable gift equal to the difference between the fair market value of the Carma Laboratories, Inc. shares transferred to the … Trust, and the note received in exchange." (That wording raises the interesting issue of what shares of stock were transferred. Under the terms of the sales agreement, only that number of shares equal to the face amount of the note was transferred.)

Estate Tax Issues. For estate tax purposes, the IRS position is that the note should not be included as an asset of Mr. Woelbing's estate, but the stock that was sold should be included in the estate under both §§ 2036 and 2038 at its date of death value. The value of the stock, according to the IRS, had increased to $162.2 million at the time of Mr. Woelbing's death.

Tax and Penalties Deficiency. The Notices of Deficiency for both estates in the aggregate allege gift and estate tax liabilities over $125 million and penalties over $25 million (asserting both gift and estate tax understatement 20% penalties). There were a few other relatively minor valuation issues involved for other properties in addition to the stock sale transaction.

Gift Tax Arguments Similar to Those in Karmazin and Dallas. In *Karmazin v. Commissioner,* the IRS made similar §2702 arguments in attacking a sale of FLP units to a grantor trust. T.C. Docket No. 2127-03, filed Feb. 10, 2003. The IRS argued that the note payments should be treated as an equity interest in the trust, that the

obligation of the trust to make the payments did not constitute a guaranteed annuity under the GRAT exception in §2702, and that the note should be treated as having a zero value for gift purposes. In addition, the sales agreement in that case conveyed "that number of units having an appraised value of $x million." (The examiner also claimed that the FLP was a sham and should be ignored.) The *Karmazin* case was settled later in 2003 on terms very favorable to the taxpayer. Under the settlement, the transaction was not characterized as a transfer of units followed by the reservation of an annuity from the trust, the interest payments paid by the trust were characterized as interest and not as an annuity, neither §§2701 nor 2702 applied, the valuation discount was reduced from 42% to 37%, and the defined value clause in the sales agreement was not given effect.

c. **Estate of Beyer.** John Porter reports that the IRS made a similar §2036 attack on a sale of limited partnership interests to grantor trusts. That case was tried in the Tax Court in December 2013 and is still awaiting decision. See Item 8.b above.

d. **Using AFR as Interest Rate for Notes in Intra-Family Sale Transactions**. IRS examiners sometimes question whether the AFR under §7872 is the appropriate interest rate for intra-family sale transactions. While §7872 does not clearly apply to sale transactions, there has been support for using the AFR as the interest rate. *See Frazee v. Commissioner*, 98 T.C. 554, 588 (1992); *True v. Commissioner*, T.C. Memo. 2001-167, *aff'd on other grounds*, 390 F.3d 1210 (10th Cir. 2004); PLRS 9535026 and 9535026. For a further discussion of these authorities, see Item 13.c of the Hot Topics and Current Developments Summary (December 2014) found here and available at www.Bessemer.com/Advisor.

The valuation of promissory notes for transfer tax purposes is a new item on the Department of Treasury 2015-2016 Priority Guidance Plan, as discussed in Item 2.a above.

e. **Planning Implications.** *Careful Planning Required*. The *Woelbing* cases are a reminder that sale to grantor trust transactions require careful planning (and there was detailed planning in the sale transaction involved in that case). Planners should be aware (and advise clients) that the IRS is alleging in some cases that the note has a zero value and that the seller makes a gift of the entire value that is transferred. Whether the IRS will prevail is another question altogether, but sales transactions with grantor trusts are clearly sophisticated transactions requiring careful detailed planning considerations. Some planners are reluctant to utilize sales to grantor trusts until there is more authority regarding the §2036 issues, but many other planners are continuing to use sales to grantor trusts with explanations to clients as described above.

Bona Fide Transaction. The planner should pay particular consideration to taking steps to cause the transaction to be treated as a "bona fide transaction" so that the note will be respected as debt rather than being treated as a retained equity interest in the trust. (If the note is treated as an equity interest in the assets that are transferred, the IRS argues that §2702 applies for gift tax purposes and that §§2036 and 2038 apply for estate tax purposes because those Code sections all involve interests retained in the transferred property itself.) Cases have listed a variety of factors that are considered by courts in determining whether intra-family loan or notes transactions are respected. E.g., *Miller v. Commissioner*, T.C. Memo. 1996-3. (As an analogy, there are

debt/equity principles that are applied under §385 in the context of shareholder loans.) There are no "safe harbor" regulations for intra-family sale transactions like there are for GRATs.

Defined Value Feature. The defined value feature of the sales agreement may become more common, especially following the *Wandry* case (T.C. Memo. 2012-88). Two prior cases (*Petter* and *Hendrix*) have recognized sale transactions with a defined value element in which "excess value" over a stipulated amount passed to charity. The clause in *Woelbing* does not involve an excess amount passing to charity but, like the gift transaction in *Wandry* (though the 2006 transaction happened long before the *Wandry* case was decided in 2012), merely defines the amount transferred in terms of a specified value amount. *Woelbing* could be the first Tax Court case addressing the validity of a "*Wandry*-type" clause in sales transactions. (*King*, *McLendon*, and *Harwood* addressed the validity of "price adjustment" clauses in sales transactions.)

Danger of Gift Splitting With Potential §2036 Issue. This case illustrates the danger of making the gift splitting election when there is a possibility that §2036 (or one of the other "string" statutes) may apply to the transfer. If the IRS is successful in its position that §2036 applies to the sale (part gift, under the IRS's position) transaction, all of the transferred stock will be included in Mr. Woelbing's estate, and §2001(b)(last sentence) provides that the gift element in his transfer will not be included as an adjusted taxable gift in his estate. However, there is no such provision that will "undo" the taxable gift of one-half of the gift element by Mrs. Woelbing.

In effect, all of the transferred asset is included in Mr. Woelbing's estate (at its date of death value) and one-half of the date of gift value is treated as a gift by Mrs. Woelbing.

Ultimately Just a Valuation Case? Is this primarily just a valuation case? (The IRS contends that the value of the transferred units was $116.8 million compared to the $59 million purchase price). Time will tell whether the IRS settles (as it did in *Karmazin*) or drops the §§2702, 2036 and 2038 arguments (it dropped a §2702 argument before trial in *Dallas*). If the case proceeds as an attack on whether the note is disregarded for gift tax purposes under §2702 and whether the sold assets are included in the seller's estate under §§2036 and 2038, this case will break new ground and provide court guidance on the requirements for a valid sale to grantor trust transaction.

Using Lifetime QTIP Trusts to Minimize §2036 Risk. Richard Franklin (Washington D.C.) suggests that a client might make a gift to a lifetime QTIP trust (making the QTIP election). The QTIP could loan cash to a grantor trust that will purchase assets from the client. Section 2036 would seem not to apply, because the client has retained no note from the grantor trust and appears to have no retained interest whatsoever in the assets that are sold to the grantor trust. Richard points out that even if an attempt were made somehow to apply a step-transaction analysis, the donor is not treated as the donor of the QTIP trust for purposes of determining whether §§2036 or 2038 applies to the QTIP trust assets at the donor's death. See Reg. §25.2523(f)-1(f) Ex. 10-11 (QTIP trust assets not included in donor spouse's estate under §§2036 or 2038 even if donor had an interest in the trust after the donee spouse's death).

10. Self-Canceling Installment Notes (SCINs); CCA 201330033 and *Estate of William Davidson*

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

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

Cases. There have been few cases addressing SCINs. In *Estate of Musgrove v. United States*, 33 Fed. Cl. 657 (1995) a demand SCIN transaction was not recognized as a bona fide transaction because of the absence of a real expectation of repayment (since the seller was in poor health and the purchaser did not have other funds and the seller declared that he was not likely to demand payment on the note), and the SCIN was included in the decedent's gross estate. *Estate of Costanza v. Commissioner*, 320 F.3d 595 (6th Cir. 2003), *rev'g*, T.C. Memo. 2001-128 recognized that a SCIN should not be ignored (the IRS argued that the sale was not a bona fide transaction) for gift tax purposes reasoning that the estate "rebutted the presumption against the enforceability of an intrafamily SCIN by affirmatively showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness."

The income tax consequences of the cancellation of note payments were addressed in *Estate of Frane v. Commissioner.* The Tax Court agreed that gain should be recognized upon the death of the seller reportable by the seller on the seller's final return, not by the seller's estate. The Eighth Circuit changed the result, adopting the IRS's alternate position that the decedent's estate recognizes the deferred gain on its initial income tax return as an item of IRD. 998 F.2d 567 (8th Cir. 1993), *rev'g* 98 T.C. 341, 354 (1992). A strong 5-judge dissent in the Tax Court decision believed that no gain results to either the decedent or the decedent's estate, reasoning that there was no

cancellation of any obligation because there was never any obligation to make any payments after the decedent's death under the terms of the agreement.

b. **Chief Counsel Advice 201330033.** The IRS Chief Counsel Office weighed in on the treatment of SCINs in Chief Counsel Advice 201330033. CCA 201330033 announces the IRS position that §7520 should not apply in valuing SCINs, but the valuation should be "based on a method that takes into account the willing-buyer willing-seller standard in § 25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account." For a more detailed discussion and analysis of CCA 201330033, see Item 39.f of the Hot Topics and Current Developments Summary (December 2013) found here and available at www.Bessemer.com/Advisor.

c. **Estate of William Davidson, Tax Court Cause No. 013748-13 (filed June 14, 2013).** *General Background.* William Davidson was the President, Chairman, and Chief Executive Officer of Guardian Industries Corp., one of the world's leading manufacturers of glass, automotive, and building products. Before various gift and sale transactions in December of 2008, he owned 78% of the common stock of Guardian. He is a prior owner of the Detroit Pistons NBA team. The decedent (age 86) entered into various gift and sale transactions in December 2008 and January 2009, including large sale transactions for self-canceling installment notes. Soon after these transactions, he was diagnosed with a serious illness and he died on March 13, 2009 (before he received any payments on the notes). The IRS Notice of Deficiency alleges gift, estate, and GST tax deficiencies of well over $2.6 billion (although the IRS acknowledges in its answer that it "did not calculate certain deductions and credits to which [the estate] may be entitled."). The case involves a wide variety of issues, but the major issues are the valuation of the Guardian stock and whether the self-canceling installment notes constituted bona fide consideration that is considered as providing any value whatsoever, or if they are bona fide, whether they provide consideration equal in value to the stock transferred in return for the notes.

   Gift and Sale Transactions. There were gift, sale and substitution transactions on three dates. All of the sales were for notes providing annual interest payments and balloon principal payments due in 5 years. The SCINs were secured by more Guardian shares than just the shares transferred in return for the SCINs. These transactions included sales of stock for hundreds of millions of dollars in two different SCIN transactions. One was for a SCIN with an 88% principal premium and the other was for a SCIN with an interest rate premium (13.43% over the §7520 rate).

   Mortality Information. The mortality tables under §7520 indicate that the life expectancy was 5.8 years at the time of the sale transactions (based on Table 90CM, which applied to transactions from May 1999-April 2009 [Table 2000CM applies to transactions from May 2009 forward]). The estate and IRS disagreed over the actual life expectancy of the decedent at the time of the sale transactions. In connection with the estate tax audit the decedent's medical records were reviewed by four medical consultants, two of whom were selected by the estate and two of whom were selected by the IRS. All four medical consultants concluded that the decedent had a greater than 50% probability of living at least one year in January 2009.

Bona Fide Transaction Issue. One possible outcome is that the court determines that the SCINs were not bona fide loan transactions (perhaps based on whether there was a reasonable expectation of repayment-and one factor in that decision will be that the SCINs are secured by more Guardian stock than just the shares transferred in return for the SCINs), and the SCINs may be valued at zero if they are determined not to represent bona fide loan transactions. The government's answer in the case states that the burden of proof is on the estate to prove that the SCINs were bona fide debt, that the decedent intended or expected to collect all payments due under the SCINs, and that the trusts would be able to make payments on the SCINs when due.

Applicability of §7520 in Valuing SCINs. If the court gets beyond the "bona fide transaction" issue, because all of the medical consultants agree that the decedent had a greater than 50% probability of living at least one year on the date of the sale transactions, the court presumably will be squarely faced with addressing whether §7520 applies in valuing SCINs. The IRS maintains that §7520 applies only in valuing annuities and life estates. The estate maintains that §7520 applies in valuing "any interest for life or a term of years," and that a SCIN requires valuing an interest that involves both a term of years and an interest for life. If §7520 applies in valuing SCINs, Reg. § 1.7520-3(b)(3) indicates that the §7520 mortality tables can be used "to determine the present value of an annuity, income interest, remainder interest, or reversionary interest" even if the individual who is a measuring life is in poor health as long as he or she is not terminally ill, defined to mean the person has a greater than 50% probability of living at least one year. The government's position in its answer is that "whether or not the decedent was terminally ill within the meaning of Treasury Regulation §1.7520-3(b)(3) is not relevant." That is precisely the dispute that may be squarely before the court.

Current Status of Davidson. **The parties have settled in *Davidson.* A stipulated decision was entered on July 6, 2015. The total federal estate and GST tax liability was $320,523,233; the stipulated deficiency was about $152 million, which is a small fraction of the amount of deficiency alleged in the Notice of Deficiency (over $2.6 billion). The SCIN sale transactions were in January 2009; the additional gift and GST tax deficiencies for 2009 were $177,981,016 and $46,275,432,respectively, compared to the combined gift and GST tax deficiency asserted by the IRS of almost $876 million. There were issues other than just whether §7520 applies to the calculation of the SCIN value (including the value of the underlying Guardian Industries closely-held stock).**

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

d. **Planning Implications for SCINs.**

- *Chill Effect.* Until there is some resolution of the IRS's position that §7520 does not apply in valuing SCINs, there is considerable uncertainty about SCIN transactions. At a minimum, the CCA and *Davidson* have placed a "chill" on SCIN transactions.

- *SCINs Will be Scrutinized If the Seller Dies "Early."* The CCA 201330033 is the first guidance about the IRS's position regarding SCINs since its loss in *Costanza*. The CCA clearly indicates that the IRS continues to view SCIN transactions in a negative light, particularly if the decedent has health issues or dies soon after the SCIN transaction. We can expect to see close examination of SCIN transactions in gift and estate tax audits.

  Income Tax Consequences of SCINs. If the seller dies before all payments have been made, the planner must understand that while this may result in a decrease in the amount included in the seller's gross estate, there are factors that may offset some or all of that advantage. If the seller dies before the SCIN matures, the IRS maintains that the deferred gain will be recognized for income tax purposes on the estate's first return. *See Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993). Some commentators (supported by the Tax Court dissent in *Frane,* 98 T.C. 341 (1992)) maintain that the cancelled gain should not be recognized as income by anyone; the five-judge *Frane* dissent reasoned that there was never any obligation to make payments after the seller's death so no indebtedness was cancelled. In addition, if the sale for the SCIN was made to a grantor trust, there may be no recognition of income on the grantor's death. There are also uncertainties regarding the purchaser's basis in the purchased assets. In any event, just be aware that there are income tax issues that may offset some of the advantages of avoiding estate inclusion for the cancelled payments. *See generally* Akers & Hayes, *Estate Planning Issues With Intra-Family Loans and Notes,* ¶517-4-517.6, 47th ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (2013).

11. STRATEGIES FOR LEAVING FLEXIBILITY OF POSSIBLE ACCESS TO GIFT FUNDS BY DONOR'S SPOUSE (OR EVEN BY DONOR)

In light of the large indexed gift exemption amount, donors are able to make large enough gifts (without paying gift taxes) that they may be concerned about whether there should be a "back door" for possible access to those funds for the donor's spouse (or perhaps even for the donor, as discussed below).

The donor may wish to make gifts in a way that the donor (or the donor's spouse) could retain some use of the assets in case needed as a "rainy day" fund. A popular way of using the increased gift exemption may be for a donor to make gifts to a "lifetime credit shelter trust" for the benefit of the donor's spouse (and possibly children). This is sometimes referred to as Spousal Lifetime Access Trusts, or "SLATs." The trust could be designed to give as much control and flexibility as possible to the surviving spouse without creating tax or creditor concerns.

a. **Overview of Major Issues**. Ellen Harrison suggests the following major issues in planning SLATs.

   - Avoid the reciprocal trust issue by making only one spouse a beneficiary, at least initially.

- Using a SLAT prevents gift splitting if the spouse's interest is not severable, ascertainable, and de minimis.
- The SLAT provides a benefit only while the donee spouse is living and married to the grantor.
  - Consider an agreement of the spouses that the gift will be taken into consideration in any property settlement incident to a divorce.
  - Consider life insurance on the donee-spouse in case the donee-spouse dies before the grantor.
  - Give the donee-spouse a limited testamentary power of appointment exercisable in favor of the grantor (but carefully consider §2036 and creditors' rights against the donor before the donee-spouse exercises the power of appointment).
  - The grantor may exercise a power of substitution (e.g.., for a long-term AFR note) if the parties divorce so that the donor would have the ability to re-acquire favored assets in the trust.
- The step transaction doctrine may treat the donee-spouse as a grantor if transfers were made by the grantor to the donee-spouse shortly before the trust was funded.
- If the SLAT is funded by the grantor with a residence, can the grantor reside in the residence without paying rent? (Presumably yes, under the reasoning of various §2036 cases that a donor's continuing to live with his spouse is not considered an implied agreement of retained enjoyment.) If the donor pays rent, is it a gift? (Presumably not.)

b. **Trust Terms**. The trust would be for the benefit of the donor's spouse, containing very similar terms as in standard credit shelter trusts created in wills. The trust may allow very broad control to the spouse but still not be included in the spouse's estate for estate tax purposes and may be protected against claims of both the donor's and spouse's creditors. In some ways, this is the ideal kind of trust for the spouse.

Possible terms could include:

- Spouse as a discretionary beneficiary (perhaps with children as secondary beneficiaries)
- Spouse as trustee (distributions to the spouse would be limited to HEMS)
- Provide that no distributions could be made that would satisfy the donor's legal obligation of support (and if distributions are made to the donee-spouse, preferably the spouse should use those distributions for things other than basic support needs to remove any inference that the funds are actually being used for the settlor's benefit)
- Spouse could have a "5 or 5" annual withdrawal power

- Spouse could have limited power of appointment (exercisable at death or in life)
- In case the donee-spouse predeceases, the power of appointment could be broad enough to appoint the assets back to a trust for the donor. (Exercising the power of appointment in the donee-spouse's will to include the donor-spouse as a discretionary beneficiary should not cause inclusion in the donor-spouse's estate under §2036(a)(1) if there was no pre-arrangement, but that might not prevent the donor-spouse's creditors from being able to reach the trust assets unless the trust is created in a self-settled trust jurisdiction. Several states have passed statutes addressing this situation for inter vivos QTIP trusts (and some states have provisions that also cover non-QTIP trusts), providing that such an appointment in trust for the donor-spouse would not cause the trust assets to be subject to the donor-spouse's creditors. The power of appointment should provide that it cannot be exercised in a manner that would grant the original donor a power of appointment over the assets to avoid triggering §2038 inclusion in the donor's estate. See subparagraph c below for further discussion.
- A "trust protector" or some independent party could be given the discretion to add the donor of the trust at some time in the future (perhaps after a number of years or after the donor is no longer married to the donor's spouse at the time the trust is created). There should be absolutely no understanding (or even implied agreement) with the protector as to how the power would be exercised.
- Another way of addressing the donee-spouse predeceasing the donor would be to have some life insurance on the donee-spouse payable to the donor or a trust for the donor-spouse that has substantially different terms than this trust.
- If the donor were concerned about how the donee-spouse might exercise the power of appointment, the instrument could provide that the power of appointment could be exercised by the spouse only with the consent of a non-adverse third party (such as the grantor's sibling), and the instrument could even provide that the third person's consent would be required in order for the donee-spouse to change an exercise of the power of appointment.
- To address the possibility of a divorce, in which event the donor-spouse may not want the donee-spouse to continue as a beneficiary, the trust could define the "spouse" to be the person to whom the grantor is married at the time without causing estate inclusion in the donor's estate. See Estate of Tully Jr. v. United States, 528 F.2d 1401 (Ct. Cl. 1976) (power to alter death benefit plan by terminating employment or divorcing wife not a §2038(a)(1) power); Rev. Rul. 80-255, 1980-2 C.B. 272 (including settlor's after-born and after-adopted children as additional beneficiaries is not the retention of a power to change beneficial interests under §§2036(a)(2) or 2038). Therefore, the trust could also be available for the benefit of a new spouse. Also, the donor and donee-spouse may enter into an agreement that the gift will be taken into consideration in any property settlement incident to a divorce.

- If the donor gets to the point that the donor really needs to be a beneficiary of the trust and wants the spouse to exercise the power of appointment, estate taxes may be the least of the donor's concerns.
- With this approach, the trust could still be used for the "marital unit" if the client has concerns that large gifts may unduly impoverish the donor and his or her spouse, but the assets would not be included in the gross estates of the donor or the donor's spouse. Such a trust would likely be a grantor trust as to the grantor under §677 (unless the consent of an adverse party were required for distributions to the spouse).

d. **Application of §§2036-2038 If Donee Spouse (or Other Beneficiary) Appoints Assets Into Trust for Benefit of Original Donor Spouse**. This issue is receiving increased attention by planners. The IRS might argue that §2036 could apply in the donor spouse's estate if it could establish an implied agreement that the donee-spouse would leave the donated assets back into a trust for the benefit of the donor spouse. This is analogous to situations in which one spouse makes a gift to the other spouse, and the other spouse bequeaths the property back into a trust for the benefit of the original donor spouse. For a discussion of various relevant cases see Item 5.j(1) of the "2012 Heckerling Musings and Other Current Developments" located here.

There is a specific exception in the QTIP regulations providing that the §2036/2038 issue does not apply for gifts to an inter vivos QTIP trust, where the assets are left back into a bypass trust for the benefit of the donor spouse. Reg. §§25.2523(f)-1(d)(1) & 25.2523(f)-1(f) Exs. 10-11. However, those examples would not apply because the rationale in them is that there will be estate inclusion in the donee-spouse's estate under §2044.

The possibility of a beneficiary exercising a power of appointment for the benefit of the grantor (or grantor's spouse) applies beyond just SLATs. Trusts for descendants or other beneficiaries may grant a beneficiary a power of appointment broad enough to allow appointing the assets to a trust that may be benefit the grantor or the grantor's spouse; the same general issues apply.

Summary of Potential Application of §2038. Section 2038 can apply to an ability to alter, amend, revoke, or terminate that exists in the trust at the death of the decedent — it did not have to be retained at the outset. So in exercising the non-general power of appointment, the donee spouse must be careful not to give the donor spouse anything that would rise to the level of a right to alter, amend, revoke, or terminate. For example, the donor could not have a testamentary power of appointment by reason of the exercise.

In addition, realize that if creditors can reach the assets in a trust to which assets have been appointed by the donee-spouse under the reasoning of the relation back doctrine (discussed below), that could create a §2038 problem, even if there was no implied agreement of how the donee-spouse would exercise the power of appointment at the time of the original transfer. While various cases that have held that assets in a trust that can be reached by the donor's creditors are in the donor's gross estate under §2036 [e.g., *Estate of Paxton v. Comm'r,* 86 T.C. 785 (1986)], some cases have also

suggested that inclusion may also result under §2038. E.g., *Outwin v. Comm'r,* 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor's spouse; gift incomplete because grantor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor's gross estate under §§2036(a)(1) or ***2038(a)(1))***.

Summary of Potential Application of §2036. The issue is whether the entire transaction and appointment back was pursuant to an implied understanding that these series of transactions would occur. Prof. Jeffrey Pennell's conclusion: "I think, frankly, it would be difficult for the government to make that case, but of course you could leave a trail of documents — a smoking gun — that could allow the government to say this was all part of a prearrangement, and that conceivably could get you into §2036."

d. **Creditor Rights Issue.** A totally separate issue is that, despite the tax rules, for state law purposes the donor to the lifetime credit shelter trust may be treated as the donor of the continuing trust for his or her benefit after the death of the donee-spouse. Therefore, for state law purposes, there is some possibility that the trust may be treated as a "self-settled trust" and subject to claims of the donor's creditors. This would seem to turn on what has been called the "relation back doctrine."Barry Nelson, Asset Protection & Estate Planning – *Why Not Have Both?,* at 15-11 2012 UNIV. MIAMI HECKERLING INST. ON EST. PLANNING ch. 17, ¶ 1701.2[B] (2012) (citing RESTATEMENT (FIRST) AND RESTATEMENT (SECOND) OF PROPERTY and a 1977 Florida case, concluding "[N]one of the reported cases regarding the Relation Back Doctrine address its application to the donor of a QTIP or credit shelter trust who receives trust assets upon the death of the donee spouse through the exercise of a special power of appointment ….").

See Alexander Bove, *Using the Power of Appointment to Protect Assets – More Power Than You Ever Imagined,* 36 ACTEC L.J. 333, 337 (2010) (after discussing the relation back doctrine in this context concludes, "Thus, it is not clear that a court would actually hold that it was a transfer from the donor to a trust for his own benefit through a power holder's discretionary exercise of a power of appointment, but it is a risk"). *See also Watterson v. Edgerly,* 40 Md. App. 230, 388 A.2d 934 (1978)(husband gave assets to wife and next day wife signed will leaving assets to trust for husband; held that the trust was protected from husband's creditors under the trust spendthrift clause).

At least nine states have statutes that address this situation in the context of initial transfers to an inter vivos QTIP trust, as opposed to transfers to a lifetime credit shelter trust. Those states are Arizona, Delaware, Florida, Michigan, Ohio, North Carolina,Texas, Virginia and Wyoming. The Arizona, Ohio, and Texas statutes also address the issue for all inter vivos trusts initially created for the donor's spouse (including the lifetime credit shelter trust strategy discussed in this sub-paragraph) where the assets end up in a trust for the original donor-spouse. ARIZ. REV. STAT. §14-10505(E-F); OHIO REV. CODE §5805.06(B)(3)(a); TEX. PROP. CODE §112.035(d)(2),(g)(effective September 1, 2013).

Gross Estate Inclusion? If the donor's creditors can reach the trust assets, that would cause inclusion in the donor's estate for estate tax purposes under §2036 if the IRS could establish the existence of an implied agreement that the spouse would exercise the limited power of appointment to appoint the assets into a trust for the donor's benefit, which creates the creditor's rights problem. However, at least one case (*Outwin v. Comm'r,* 76 T.C. 153 (1981)) also states that §2038 could apply if the donor's creditors can reach the trust assets, and §2038 does not require an implied agreement of a retained interest at the time the gift is originally made, but only looks to conditions that exist at the donor's death. Accordingly, it may be important to exercise the limited power of appointment to establish a new trust in a "self-settled trust state" or a state that has passed a law similar to the Arizona, Ohio and Texas statutes discussed above. However, even using a "self-settled trust state" for the new trust provides no absolute protection; the donor's state of domicile may refuse to recognize the asset protection features of the new trust on public policy grounds. The state of the donor's residence may assert that public policy prevents using an asset protection trust in another state. See *Huber v. Huber,* 2013 WL 21454218 (Bkrtcy. W.D. Wash. May 17, 2013) (under §290 of the Restatement (Second) of Conflict of Laws (1971), the choice of law designated in the trust is upheld if it has a substantial relation to the trust considering factors such as the state of the settlor's or trustee's domicile, the location of the trust assets, and the location of the beneficiaries; held that Washington State has a strong public policy against self-settled asset protection trusts and that the trust instrument's designation of Alaska law is disregarded under the principles of §270 of the Restatement); *In re Herbert M. Zukerhorn,* BAP No. NC-11-1506, U.S. Bankruptcy Appellate Panel of the Ninth Circuit (Dec. 19, 2012)(dictum).

e. **Gift From One Spouse With Split Gift Treatment**. Instead of having each spouse make $5 million gifts, some planners have suggested that one spouse could give the entire $10 million to a trust having the other spouse as a discretionary beneficiary. The other spouse would make the split gift election, which treats him or her as the transferor for gift and GST tax purposes (meaning that the spouse's gift and GST exemption could be used) but NOT for estate tax purposes. Therefore, the assets would not generally be included in the spouse's gross estate for estate tax purposes even though he or she was a discretionary beneficiary. The problem with this approach is that split gift treatment is not allowed if the consenting spouse is a beneficiary of the trust unless the spouse's interest in the trust is ascertainable, severable and de minimis. *See* Rev. Rul. 56-439, 1956-2 C.B. 605; *Wang v. Commissioner,* T.C. Memo 1972-143 (no split gift election allowed where consenting spouse's interest in trust receiving gift assets was not ascertainable); *Robertson v. Commissioner,* 26 T.C. 246 (1956)(gift splitting allowed for full amount transferred); *see generally* D. Zeydel, *Gift-Splitting — A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules,* 106 J. TAX'N 334 (June 2007). Interestingly, Ltr. Rul. 200130030 allowed gift splitting for the full amount of the transfer without discussing the value [in particular, that it had no value] of the donee spouse's severable interest).

While the *amount* that can qualify for gift splitting may be limited for gift purposes, the regulations appear to provide that if any portion of the transfer qualifies for gift splitting, a full one-half of the transferred amount shall be treated as having been transferred by the consenting spouse for GST purposes. Reg. §26.2652-1(a)(4).

For a more complete discussion of the relevant cases and letter rulings, see Item 5.j(3) in the December 2012 "Estate Planning Current Developments and Hot Topics" found here.

Gift splitting should be allowed in full if:

- Distributions of both income and principal to the donee-spouse are subject to an ascertainable standard of distribution under §2514, preferably a standard based upon the spouse's accustomed standard of living;
- The trustee must consider other resources available to the spouse before exercising its discretion to distribute income or principal to the spouse; and
- The resources that are, and are expected to be, available to the spouse for the remainder of his or her lifetime are sufficient to meet the spouse's living expenses, such that the likelihood that the trustee will need to exercise its discretion to distribute income or principal to the spouse is so remote as to be negligible.

f. **"Non-Reciprocal Trusts."** If the "rainy day" concern can be accommodated by having only one spouse make a gift to a trust with the other spouse as a discretionary beneficiary, that is far preferable. The gift by the other spouse would be to a trust with only descendants as beneficiaries. That clearly avoids the reciprocal trust doctrine (although an issue could arise if the spouses serve as trustees of each other's trust). Some clients may want to go further and have each of the spouses create credit shelter trusts for the other spouse; the issue would be whether such trusts could be structured to avoid the reciprocal trust doctrine and therefore avoid estate inclusion in both spouses' estates.

If A creates a trust for B, and B creates a trust for A, and if the trusts have substantially identical terms and are "interrelated," the trusts will be "uncrossed," and each person will be treated as the grantor of the trust for his or her own benefit. United States v. Grace, 395 U.S. 316 (1969). In Grace, the trust terms were identical, the trusts were created 15 days apart, and the trusts were of equal value. The Court reasoned:

> Nor do we think it necessary to prove the existence of a tax-avoidance motive. As we have said above, standards of this sort, which rely on subjective factors, are rarely workable under the federal estate tax laws. Rather, we hold that application of the reciprocal trust doctrine requires only that the *trusts be interrelated,* and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the *same economic position* as they would have been in had they created trusts naming themselves as life beneficiaries. (Emphasis added)

If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. *See Estate of Levy v. Commissioner,* 46 T.C.M. 910 (1983); Letter Ruling 200426008; *but see Estate of Green v. United States,* 68 F.3d 151 (6th Cir.1995) (Jones, J. dissenting).

Possible distinctions that could be built into the trusts include:

- Create the trusts at different times (separated by months, not 15 days as in *Grace*)
- Fund the trusts with different assets and different values (observe that *Grace* holds that just having different assets is not sufficient to avoid the doctrine, but it

applies only to the extent of mutual value, *Estate of Cole v. Comm'r,* 140 F.2d 636 (8th Cir. 1944))

- One trust allows distributions without any standard but the other trust imposes a HEMS standard
- One trust might require considering the beneficiary-spouse's outside resources and the other would not
- One of the spouses would become a discretionary beneficiary only after the lapse of some specified time (say, 5 years) or on the occurrence of some event (for example, Letter Ruling 200426008 addresses trusts under which (i) husband would not become a beneficiary of wife's trust until three years after wife's death and then only if the husband's net worth did not exceed a specified amount and his income from personal services was less than a specified amount, and (ii) wife had a "5 or 5" withdrawal power from husband's trust after their son's death)
- One trust includes the donor's spouse as a discretionary beneficiary but the other trust would merely give an independent party (not exercisable as a fiduciary), perhaps after the passage of some specified time, the authority to add that donor's spouse as a discretionary beneficiary
- One trust allows conversion to a 5% unitrust but the other trust prohibits that
- Different termination dates and events
- Inter vivos power of appointment in one trust and not the other (like *Levy*)
- Different testamentary powers of appointment (maybe one trust has one and the other does not or perhaps there are different classes of permitted appointees or perhaps in one trust the power is exercisable only with the consent of a non-adverse party)
- Different trustees
- Different removal powers (one allows the grantor to remove and comply with Rev. Rul. 95-58 but the other puts removal powers in the hands of some third party).

There may be an advantage to making the primary beneficiary the Settlors' grandchildren, and including each other only as secondary beneficiaries.

In any event the differences need to be "real." Additionally, the structure of the trusts is only part of the equation, and probably not the most important part. How the trusts are *administered after they are created* may be the most critical factor. Clients may want to make gifts to the trusts and then immediately start flowing cash out of the trusts to each other the same as they did before the trusts were created. If that is done, the IRS would likely argue the existence of a pre-arranged plan that the income or other benefits would come right back to the grantor, even if only indirectly through the spouse.

Consider not having each of the spouses serve as trustee of the other's trust. Reciprocal dispositive powers may be sufficient to invoke the reciprocal trust doctrine if the trusts are sufficiently interrelated; reciprocal economic interests may not be

required. *See Bischoff v. Commissioner, 69 T.C. 32 (1977); Exchange Bank & Trust v. United States*, 694 F.2d 1261 (Fed. Cir. 1982).

For a more complete discussion of the reciprocal trust doctrine, authorities holding that the reciprocal trust doctrine does not apply if there are substantial differences between trusts, authorities for applying the doctrine to reciprocal powers, and related creditor's rights issues see Item 5.I of the December 2012 "Estate Planning Current Developments and Hot Topics" found here (available at www.Bessemer.com/advisor website).

Creditor's Rights Issue? A possible concern with "non-reciprocal" trusts by each of the spouses for each other is that they may not be respected for state law purposes with respect to claims of creditors against the settlors. Cf. Security Trust Co. v. Sharp, 77 A.2d 543 (Del. Ct. Ch. New Castle 1950)(case did not involve a creditor attack on a reciprocal trust, but suggested in dictum that reciprocal trusts would be subject to attack by creditors). The Security Trust case was over 60 years ago, and it is difficult to locate any reported case in which creditors have attacked a reciprocal trust under this theory.

State legislatures may address this issue. An Arizona statute provides protection from a reciprocal trust attack when spouses create trusts for each other. ARIZ. REV. STAT. §14-10505(E).

The possibility of creditors attacking reciprocal trusts should not be a problem if the trusts are created under the laws of states that have adopted "self-settled spendthrift trust" provisions (as discussed in the following paragraph).

If the donors' creditors can reach the trust assets, that would cause inclusion in the donors' estates for estate tax purposes under §2036 (and possibly under §2038).

g. **Discretionary Trusts in Self-Settled States**.

(1) *Self-Settled Trust States.* Self-settled trusts may be considered in jurisdictions that allow distributions to the settlor in the discretion of an independent trustee without subjecting the trust to claims of the settlor's creditors (and therefore estate inclusion). This will raise the issue of whether a client can create a trust, with the possibility of it serving as a "rainy day fund" in the unlikely event that financial calamities occur, without triggering §2036(a)(1) (a transfer with an implied agreement of retained enjoyment).

Thirteen states have adopted varying approaches regarding "self-settled spendthrift trusts": Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio (the most recent state to adopt a self-settled trust statute), Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming. (In addition, Oklahoma law provides that the a settlor's creditors cannot reach the assets of a revocable trust up to $1 million established for the settlor's spouse, descendants or charities, but this does not recognize "self-settled trusts" because the settlor cannot be a beneficiary of that trust.) Self-settled trusts, with the grantor as a discretionary beneficiary, can be used to overcome the concern of some clients that they will run out of money. Establish the trust in one of those states so that creditors do not have access to the trust.

Choosing the laws of a "self-settled trust state" as the governing law for the trust, however, provides no absolute protection if the settlor does not reside in that state or unless the trust otherwise has significant contacts with that state. The settlor's state of domicile may refuse to recognize the asset protection features of the trust on public policy grounds. The state of the settlor's residence may assert that public policy prevents using an asset protection trust in another state. See Huber v. Huber, 2013 WL 2154218 (Bkrtcy. W.D. Wash. May 17, 2013) (under §290 of the Restatement (Second) of Conflict of Laws (1971), the choice of law designated in the trust is upheld if it has a substantial relation to the trust considering factors such as the state of the settlor's or trustee's domicile, the location of the trust assets, and the location of the beneficiaries; held that Washington State has a strong public policy against self-settled asset protection trusts and that the trust instrument's designation of Alaska law is disregarded under the principles of §270 of the Restatement); *In re Herbert M. Zukerhorn,* BAP No. NC-11-1506, U.S. Bankruptcy Appellate Panel of the Ninth Circuit (Dec. 19, 2012)(dictum).

(2) *Section 2036 Concerns.* Creating the trust under the laws of a self-settled trust state can help alleviate concerns that §2036 may apply to the trust. Furthermore, the trust could be structured to include only the settlor's spouse as beneficiary as long as the settlor is married — so that the settlor is not even a direct beneficiary as long as he or she is married. The potential §2036 concern could be further ameliorated by giving someone the power to remove the settlor as a beneficiary, and that power could be exercised when the settlor is near death. Whether a retained enjoyment exists under §2036 is tested at the moment of death, and §2035 should not apply because the settlor has nothing to do with removing himself or herself as beneficiary (as long as no prearrangement exists). See Tech. Adv. Memo. 199935003 (§2035 will apply if pre-planned arrangement).

A §2036 concern may arise if the settlor ever needs distributions from the trust and distributions are made to the settlor. That might give rise to at least an argument by the IRS of a pre-arrangement or implied agreement that distributions would be made when requested. Of course, if the settlor gets to the point of needing distributions from the trust, estate tax concerns may be the least of the settlor's worries.

One alternative approach is to provide that an independent trust protector could add the settlor as a discretionary beneficiary at a later time, but only if the settlor's net worth falls below a specified level that is far less than the settlor's current net worth. That could help establish the absence of any "retained" benefit includable under §2036.

Private Letter Ruling 200944002 addressed an Alaska trust and recognized that the "trustee's authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under §2036" as long as state laws provide that including the grantor as a discretionary beneficiary does not cause the trust to be subject to claims of the grantor's creditors. However, the ruling expressly declined to give an unqualified ruling and noted that the discretionary authority to make distributions to the grantor

"combined with other facts (such as, but not limited to an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under §2036." Beginning in late 2011, the IRS has told other parties requesting similar rulings that it is not willing to issue further similar rulings. According to counsel, the Service's unwillingness to rule is not attributable to family exceptions or other differences under the laws of other states. Rather, the Service appears to be troubled by commentary about the Mortensen Alaska bankruptcy case. Battley v. Mortensen, Adv. D.Alaska, No. A09-90036-DMD (2011) allowed the bankruptcy trustee to recover assets transferred to an Alaska "self-settled trust" under the 10-year "clawback" provisions of §548(e) of the Bankruptcy Act. The agents at the Service said that PLR 200944002 probably wouldn't have been issued if they were looking at it now and that the Service since has declined other Alaska ruling requests.

PLR 200944002 is consistent with prior cases that have analyzed gross estate inclusion under §2036 in part based on whether trust assets can be reached by any of the grantor's creditors. For further discussion of those cases and §2036 issues surrounding the use of self-settled trusts, see Item 5.l of the December 2012 "Estate Planning Current Developments and Hot Topics" found here.

(3) *Potential Incomplete Gift Issue.* Some planners have expressed concern that the IRS might take the position that the gift is an incomplete gift, because of the possibility (perhaps, however remote) that creditors might be able to reach the assets. E.g., Outwin v. Comm'r, 76 T.C. 153, 162-65 (1981)(gift to trust incomplete if creditors can reach trust assets); Herzog v. Comm'r, 116 F.2d 591 (2d Cir. 1941)(gift to trust is completed gift if state law provides that settlor-beneficiary's creditors could not reach the trust corpus or income). The Illinois Supreme Court recently held that a decedent's creditors could reach assets that had been transferred to a Cook Islands trust. *Rush University Medical Center v. Sessions*, 2012 Ill. 112906 (2012). That case involved an egregious fact situation in which an individual transferred almost all of his assets to a Cook Islands trust of which the settlor was a discretionary beneficiary, knowing that he had made a large charitable pledge and that his remaining assets would not be sufficient for his estate to satisfy the pledge. The court did not address which jurisdiction's law should apply under relevant conflict of laws principles, but held that the state's passage of a fraudulent conveyance statute did not supersede Illinois common law principles allowing the creditors of a settlor to reach trust assets to the extent that the trust assets could be distributed to the settlor. In Rush University, the Cook Islands trust owned real estate in Illinois that had sufficient value to satisfy the judgment, so apparently there was no issue about having to enforce the judgment in the Cook Islands. That case has caused concern among some planners about whether transfers to domestic asset protection trusts might arguably be incomplete gifts if the settlor resides and has assets in another jurisdiction that does not have "self-settled trust" legislation.

h. **Sale for Note or Annuity**. A sale transaction is a "leaky" freeze, but may leave the client in a much more comfortable position than making gifts of $5 million (or $10 million for couples). For example, a client may make a smaller gift to a grantor trust,

but make a sale of $10 million. The client continues to have access to principal and interest on the $10 million note, as compared to a $10 million outright gift where there is no retained benefit. A "leaky" freeze may not be perfect from an estate planning perspective, but the client may be much more comfortable. "Don't let the perfect get in the way of the good if the only way to get anything done is a leaky freeze."

If a client has long ago made transfers to a grantor trust, the client might consider selling substantial assets to the trust in return for a lifetime annuity. An "old and cold" trust should be used to build the best arguing position that the transfer is made for full consideration so that § 2036 should not apply. The trust would have to contain sufficient assets to satisfy the "exhaustion" test described in Reg. §§ 25.7520-3(b)(2)(i), 20.7520-3(b)(2)(i) and 1.7520-3(b)(2)(i), which assumes that the measuring life will live to age 110. If the trust does not have sufficient assets to cover all of the exhaustion test, it may be possible for individuals to guarantee the annuity to avoid the impact of the exhaustion test.

i. **Transfer of Residence to Trust or Co-Tenancies Between Grantor/Spouse of Grantor and Trust**.

Clients often prefer gifting residences or vacation homes to a trust rather than gifting cash and securities. If all of the residence is transferred to the trust, the grantor should be able to avoid inclusion in the grantor's estate under §2036 even if the grantor uses the residence, as long as the grantor pays fair market rent for any use of the residence.

(1) *Payment of Fair Market Rent.* Applying §2036 if the grantor pays a fair rent is problematic, because the statute only applies to transfers for less than full and adequate consideration, and the donor would be paying full consideration for the right to use the property. It is ironic that paying rental payments would even further deplete the donor's estate. However, the trend of the cases is not to apply §2036 where adequate rental is paid for the use of the property. *E.g., Estate of Barlow v. Comm'r*, 55 T.C. 666 (1971) (no inclusion under §2036 even though decedent stopped paying rent after two years because of medical problems); *Estate of Giselman v. Comm'r*, T.C. Memo 1988-391. The IRS has ruled privately in several different rulings that the donor of a qualified personal residence trust may retain the right in the initial transfer to lease the property for fair rental value at the end of the QPRT term without causing estate inclusion following the end of the QPRT term under Section 2036. *E.g.*, Ltr. Rul. 199931028. However, the IRS does not concede that renting property for a fair rental value always avoids application of Section 2036. *See* Tech. Adv. Memo. 9146002 (*Barlow* distinguished). Most of the cases that have ruled in favor of the IRS have involved situations where the rental that was paid was not adequate. *E.g., Disbrow v. Comm'r*, T.C. Memo 2006-34 (court also concluded that the annual lease agreements were a subterfuge to disguise the testamentary nature of the transfer for various reasons); *Estate of Du Pont v. Comm'r*, 63 T.C. 746 (1975).

For a more complete discussion of the effect of paying fair market rent, see Item 17.b(4) of the "2012 Heckerling Musings and Other Current Developments" found here.

(2) *Grantor Trust to Avoid Rental Income Recognition*. If the donor pays rent to a grantor trust, there is no recognition of rental income because the donor is treated as paying rent to herself. However, rent paid to a spouse or to a trust treated as owned by the renter's spouse under the grantor trust rules is taxable income (because §1041 merely provides that there is no income recognition for "transfers" between spouses). *See Gibbs v. Comm'r*, T.C. Memo 1997-196 (recognition of interest income on payment of interest from the grantor's spouse).

(3) *Co-Tenancy to Avoid Paying Rent (or Reduce Rent).* Although paying rent further depletes the value of the donor's estate for estate tax purposes, the idea of paying rent to the trust is not appealing to some clients, although fair market rent may not be much more than the ownership costs shifted to the trust for paying real estate taxes, insurance, and major maintenance costs. If a fractional interest is given to the trust, with the donor retaining a fractional interest, the donor would not have to pay rent with respect to the retained interest. Where only a fractional interest in a property is transferred, the donor may retain proportionate use of the property consistent with the retained ownership. *Estate of Wineman v. Comm'r*, T.C. Memo. 2000-193 (2000).

To go a step further — co-tenants are each entitled to nonexclusive possession rights, so can the donor continue to live in the residence because of his or her retained undivided co-tenancy interest without paying rent as long as the donor does not want exclusive possession of the residence? *Stewart v. Comm'r*, 617 F.3d 148 (2d Cir. 2010) involved a situation in which a mother and son both co-occupied a residence. The mother transferred a 49% undivided interest in the residence to the son and they both continued living there. The court (over a strong dissent) stated that "co-occupancy of residential premises by the related donor and donee is highly probative of the absence of an implied agreement." The court suggested a test for residential premises, providing that if there is both "continued exclusive possession by the donor and the withholding of possession from the donee," §2036(a)(1) will apply. The court suggested strongly that §2036(a)(1) would not apply if there is continued occupancy by both owners.

Use a tenancy in common rather than joint tenants with right of survivorship (because §2040 causes estate inclusion for the donor except to the extent that the transferee pays consideration).

For a more complete discussion of the effect of co-tenancies and the ability to continue to use a residence as a co-tenant without invoking §2036 see Item 17.b of the "2012 Heckerling Musings and Other Current Developments" available at the www.Bessemer.com/advisor website.

j. **Inter Vivos QTIPable Trust**. A spouse could make a gift to a "QTIPable" trust for the other spouse. Advantages of this planning approach include the following:

(1) *Defer Taxable Gift Decision.* The grantor can defer the decision of whether to treat the transfer as a taxable gift utilizing the grantor's lifetime gift exemption amount (or requiring the payment of current gift taxes) until the grantor's gift tax return is filed (possibly until October 15 of the following calendar year). If the grantor decides that it would be best not to make a taxable gift, the grantor would make a

QTIP election so that the transfer qualifies for the gift tax marital deduction (in which event the trust assets will be included in the donee-spouse's estate for estate tax purposes). If the grantor decides to treat the transfer as a taxable gift (using up the gift exemption or requiring the payment of gift tax), the QTIP election would not be made. For example, if the assets decline in value substantially, the grantor may decide not to treat the transfer as a taxable gift using up gift exemption based on the higher date of gift value.

(2) *Formula QTIP Election as Defined Value Approach.* Though untested by cases but apparently allowed by regulations, a formula QTIP election may allow the grantor to limit gift tax exposure to a desired specified amount. In effect, this would have the same advantages of defined value clauses, and would be based on provisions in regulations allowing formula QTIP elections. See Treas. Reg. §§20.2056(b)-7(b)(2)(i) & 20.2056(b)-7(h) Exs. (7-8). For a discussion of the mechanics of making a formula election, see Tech. Adv. Memo. 9116003 (discussing validity of QTIP election of "an amount from the assets ... equal to the minimum amount necessary to reduce the federal estate tax payable as a result of my death to least amount possible …").

(3) *GST Exemption Allocation.* There is flexibility to allocate the grantor's GST exemption (by making a "reverse QTIP" election under §2652(a)(3)), to allocate the spouse's GST exemption, or not to allocate any GST exemption to the trust. This decision can be deferred until when the gift tax return is due (possibly until October 15 of the following year).

(4) *No Clayton QTIP For Inter Vivos QTIPs.* The "Clayton regulation" provides that for testamentary transfers, the instrument can provide that the portion of the assets for which the QTIP election is not made may pass to a trust having different terms than the required terms for a QTIP trust — including a trust that would be similar to a standard "bypass trust" for the spouse and descendants and that would not be in the spouse's estate for estate tax purposes. However, there is no similar regulation that clearly applies for gift tax purposes for inter vivos transfers. The Clayton provision in Treas. Reg. §20.2056(b)-7(d)(3) appears only in the estate tax regulation — it is not also in the similar gift tax regulation, Reg. §25.2523(f)-1(b). Indeed, if a Clayton provision added other beneficiaries if the QTIP election is not made, it would seem that the gift would not be complete in the year of the original transfer — because the donor would retain the power to shift benefits among beneficiaries until the gift tax return filing date has passed. (Conceivably the gift would never become complete during the donor's lifetime because the return making the election would always be due the following year, thus extending the completion of the gift to the following year, extending the due date of the return to the year after that, etc.)

12. Giving Business Interests to Charity

The discussion in this Item regarding giving business interests to charity is a summary of comments by Turney P. Berry and Jeffrey C. Thede at the American College of Trust and Estate Counsel 2015 Annual Meeting.

a. **Planning Challenge in Giving Business Interests to Charity**. The owner of a business could easily just prepare a stock or LLC member interest assignment conveying the interest to charity. The charity probably does not want to own or manage a business, so the charity would likely look to sell its interest in the business. A business interest could even be conveyed to a private foundation (though the excess business holdings rule would mean that the charity would eventually need to sell the business to someone). That works as long as the foundation sells the business to an unrelated person.

   The difficulty is that no one wants to do that—typically the goal is for the business or family to purchase back the business interest that is conveyed to the charity.

b. **Substantiation Letter Requirement.** Since 1993, no income tax charitable deduction is allowed for any contribution of cash or other property valued at $350 or more unless the donor receives "contemporaneous written acknowledgment" from the charity before the earlier of the actual filing date or the due date (including extensions) for filing the return that claims the deduction, or else the deduction is disallowed in its entirety. §170(f)(8); *See Durden v. Commissioner*, T.C. Memo. 2012-140 (charitable deduction was denied for cash contribution to church because receipt letter did not have the required sentence that the taxpayer did not receive any goods or services and receipt of a proper letter after the taxpayers received the notice of deficiency was not sufficient). (This requirement applies even to trust-form private foundations of which the donor is the sole trustee.) There is no similar requirement for the gift or estate tax charitable deduction, but the donor must provide information that may be requested by the IRS. For charitable gifts by S corporations or partnerships, the receipt need only be given to the entity, even though the shareholders/partners may claim the flow-through deductions on their personal returns. Reg. §1.170A-13(f)(15).

c. **Appraisal Requirements.** The donor must obtain a "qualified appraisal" of property valued at more than $5,000 (with some exceptions, discussed below) and attach an "appraisal summary" (Form 8283) to the income tax return claiming a charitable deduction, or else the deduction is disallowed in its entirety. §170(f)(11)(C)-(D). (The $5,000 threshold applies on an annual basis for all gifts of the same or "similar" items even if made to different organizations.) An appraisal is not required for gifts of cash or publicly traded securities and is not required for non-publicly traded stock if the deduction involved is less than $10,000. Reg. §1.170A-13(c)(2)(ii).

   Most of the reported cases have required strict compliance with the appraisal rules, but a few cases have recognized substantial compliance with the rules.

d. **Private Foundation Restrictions—Generally.** Punitive taxes are imposed on foundations, foundation managers, and "disqualified persons" involved in:

   - Self-dealing actions (§4941);
   - Failure to make qualifying grants of a minimum amount each year, typically 5% (§4942);
   - Excess business holdings (generally more than 20% (less the amount held by disqualified persons) of the voting stock in a corporation holding an active business (or profits interest of a partnership; the 20% limit is increased to 35% if effective control is not held by disqualified persons); the charity has five years to dispose of excess business holdings acquired by gift or bequest (§4943);

- "Jeopardy investments" (§4944); and
- "taxable expenditures," including grants for impermissible purposes (§4945).

Charitable Remainder Trust Application. The self-dealing restrictions apply to CRTs (§4947(a)(2)), but the excess business holdings and jeopardy investment restrictions apply only if the designated income beneficiaries include charitable organizations (§4947(b)(3)).

Charitable Lead Trust Application. The self-dealing restrictions apply to CLTs, but the excess business holdings and jeopardizing investments restrictions apply only if the present value of the charitable income interest exceeds 60% of the fair market value of the trust assets at creation (§4947(b)(3)).

e. **Self-Dealing Prohibition and Exceptions**.

(1) *Significance*. Potential self-dealing transactions are scary from a planner's standpoint. If there are uncertainties in the creation of an exempt organization, the application can be submitted and revised as needed in order for the IRS to grant a favorable ruling. If a transaction arises that might be self-dealing, the taxpayer can submit a ruling request through the normal process, but that is expensive. For smaller transactions, the planner may make its best call and file returns. If the planner is wrong, the taxpayer must pay penalties AND undo the transaction (and undoing the transaction may be *very* difficult). The government could even make a criminal fraud argument against the return preparer (one of the panelists was an expert witness in a criminal fraud case involving an allegation of a failure to report a self-dealing transaction). The lack of certainty can be most troubling.

For an excellent discussion of planning alternatives to avoid the self-dealing rules, see Richard Fox & Jonathan Blattmachr, *Avoid Unintentional Self-Dealing With Private Foundations,* 42 EST. PLANNING 2, 11 (August 2015).

(2) *General Rule*. The self-dealing rule effectively prohibits almost any transaction between the foundation and a donor, members of the donor's family, or other "disqualified persons" (as described in §4946). This *generally* includes sales, leases, loans, compensation payments (but a private foundation can pay reasonable compensation to a disqualified person, §4941(d)(2)(E)), or providing services. §4941. The restriction applies regardless of the sufficiency of consideration, and the IRS has no equitable authority to excuse harmless violations.

(3) *Probate Exception*. Under the very important "probate exception," a transaction relating to a foundation's interest in property held by an estate (or revocable trust becoming irrevocable on the grantor's death) is permissible if:

(i) the personal representative or trustee either has a power of sale, a power to reallocate the property to another beneficiary, or is required to sell under an option that was binding when the estate received the property;

(ii) the transaction is approved by the court;

(iii) the transaction occurs before the estate is terminated;

(iv) the estate receives an amount that equals or exceeds the fair market value of the foundation's interest in the property at the time of the transaction, considering

the terms of any outstanding option that applied when the estate received the property; *and*

(v) the transaction either (i) results in the foundation receiving something at least as liquid as what it gave up, (ii) results in the foundation receiving an asset related to its exempt function, *or* (iii) is required under a binding option. Reg. §53.4941(d)-1(b)(3).

(4) *Purchase With Promissory Note Under Probate Exception.* One of the substantial advantages of the probate exception over the "corporation adjustment" exception (discussed below), is that the corporate redemption exemption requires a cash purchase, and the estate exception does not require a cash purchase. Accordingly, if a will leaves stock of a family business to a foundation, and if the family wishes to purchase the stock, the purchase is often accomplished under the estate exception so that the family members can give a promissory note to the estate for the stock, and the note will then pass to the foundation. The note is typically at least as liquid as the stock itself (at least if the note is negotiable), and the primary issue is whether the note equals or exceeds the value of the stock that was purchased.

Various letter rulings have approved the transfer to a private foundation of a promissory note from a disqualified person as the obligor. *See e.g.,* PLRs 201206019, 200729043, 199924069. The IRS stopped issuing probate exception rulings in 2012 "in cases in which a disqualified person issues a promissory note in exchange for property of an estate or trust." Rev. Proc. 2012-4. The IRS has continued each year since with that same no-ruling policy. Recent rulings have affirmed, however, that notes can be used to purchase assets from an estate under the probate exception. *See* PLR 201407023 ("except in the case of the receipt and holding of a note pursuant to a transaction described in §53.4941(d)-1(b)(3)," quoting Reg. §53.4941(d)-2(c)).

Interest Rate. Can the AFR be used on the note? When the IRS was issuing rulings, it gave favorable rulings in several situations for promissory note with AFR interest rates. PLRs 201206019, 201129040, 200124029. In these rulings, however, the taxpayer represented that the note had a value equal to the purchased property and the IRS made specific reference to that representation in its conclusion. Reg. §53.4941(e)-1(f) says that fair market value is determined pursuant to Reg. §53.4942(a)-2(c)(4), which in turn references principles stated in §2031. There is no specific authority in §2031 for using the §7872 AFR rate for valuing loans for estate tax purposes. Some commentators are skeptical about being able to use the AFR interest rate on a note with a face value equal to the value of the property being purchased under the probate exception. *E.g.,* Richard Franklin & Jennifer Goode, *The Intermediary CLAT Alternative to the Residuary Estate Family Foundation Gift*, 39 ACTEC L.J. 355, 361-362 n.15 (Winter 2013) ("The basic idea of the self-dealing rules is to prohibit a disqualified person from gaining an advantage at the foundation's expense. To construe the estate administration exception as allowing a disqualified person to garner a bargain rate of interest using the current low AFRs would seemingly violate the sprit [sic] of the self-dealing rules.").

Term of Note. Planners are comfortable using a 10 year note—but not a 99 year note. A 30-year note is a standard home mortgage length, but is beyond the comfort range of many planners for purchases under the probate exception.

(5) *Corporate Adjustment Exception*. Stock redemptions (and other corporate transactions) between a foundation and a corporation that is a disqualified person (generally one that is owned more than 35% by disqualified persons, §4946 (a)(1)(E) & (a)(3)) are permissible if:

(i) the corporation offers to all the shareholders the opportunity to redeem "all the securities of the same class … subject to the same terms and conditions";

(ii) the redemption offer constitutes a "bona fide offer" to redeem from all the shareholders; and

(iii) the redemption price is "no less than fair market value." §4941(d)(2)(F); Reg. §53.4941(d)-3(d)(1). The IRS has issued various favorable rulings even in situations in which the parties anticipate that only the foundation's interest will be redeemed. *E.g.*, PLRs 200720021, 9338046, 9108030, 9015055.

Cannot Use Promissory Note. Generally speaking, loans from a foundation to a corporate disqualified person are impermissible self-dealing. PLR 9347035 approved a redemption under the corporate adjustment exception with an "installment payment arrangement," but that PLR was revoked in PLR 9731034 ("Subsequent to the issuance of the ruling it was discovered that the ruling was contrary to Example 2 of section 53.4941(d)-3(d)(2) of the … regulations").

(6) *Similar Rules for DAFs and SOs*. Similar rules apply for donor advised funds and supporting organizations. The Pension Protection Act of 2006 added certain transactions involving DAFs or SOs as automatic "excess benefit transactions" under §4958, subject to excise taxes as high as 200%. In some ways, these rules are more restrictive than the private foundation self-dealing rules and the class of disqualified persons is broader. An excess benefit transaction includes any grant, loan, compensation, or similar payment from the fund to donors, fund advisors, or a very broad variety of other disqualified persons, as well as distributions resulting in more than an "incidental benefit" to a donor, fund advisor, or other disqualified person. §§4958(c)(2), 4966, 4967. In some respects, however, the rules for DAFs and SOs are narrower than for private foundations. For example, if a $30 million business is owned 1% by the family and 99% by a DAF, and if the DAF's 99% interest is redeemed for cash (using the proceeds from a bank loan) for $20 million (leaving the family owning all of the stock of a business with a net worth of $10 million), the excess benefit restrictions do not literally apply because there has been no distribution to a disqualified person. ("The excess distribution rules apply to things like tables at an event. It is an insult to our intelligence--like we can't be more offensive than that?")

f. **Excess Business Holdings Restriction**. A private foundation can hold only very limited interests in an unrelated business enterprise. For a corporation holding an unrelated active business, the foundation and disqualified persons together generally may not own more than 20% of the voting stock, but this is increased to 35% if a third person has effective control §4943(c)(2)(A)-(B). If all disqualified persons together own no more than 20% of the voting stock, the foundation can own nonvoting stock (in any amount).

§4943(c)(2). Similar rules exist for partnerships and LLCs, but a foundation may not hold any business enterprise operated in proprietorship form. A business that derives at least 95% of its gross income from "passive sources" is excepted from these rules. If a foundation has excess business holdings, there are varying rules as to how long the foundation has to dispose of the interest. For example, if it acquired the interest by gift or bequest, if has five years (§4943(c)(6)), and the IRS in its discretion can grant another five-year extension if the foundation can show that it made diligent efforts to dispose of "an unusually large gift or bequest or diverse holdings or holdings with a complex corporate structure" but was unable to dispose of the holdings within the initial five-year period except at substantially below fair market value. §4943(c)(7).

The excess business holdings rules do not generally apply to DAFs and SOs.

g. **Charitable Gift to Single Member LLC Owned by Charity**. Notice 2012-52 provides that for purposes of §170(b) (*i.e.*, for income tax purposes) a gift to a single member LLC owned by the charity is treated as a contribution to the charity. (The charity, rather than the LLC, satisfies the substantiation requirements.) To avoid confusion, the IRS encourages the charity to disclose in its acknowledgement of the contribution that the LLC is wholly owned by the charity and is treated by the charity as a disregarded entity. This can be very helpful, for example, if someone is contributing real estate (with inherent liability for accidents occurring on the property or with a potential environment liability). The charity could form a single member LLC to hold the property to segregate any liability associated with the property from the charity's assets.

Presumably, the IRS will apply the same rule for purposes of the gift and estate tax charitable deduction, but there is always the danger that the IRS would not follow the same approach in perceived abusive transactions.

h. **Charitable Gifts of C Corporation Stock**.

(1) *Practical Reality.* Attorneys get calls from charitable development officers who say they have been approached by a prospective donor who is selling its stock in a business and wants to involve the charity. Invariably, the transaction actually ends up involving an LLC taxed as a partnership, or an S corporation, or a C corporation that is selling its assets rather making a stock sale, or that is making a §338 election to be treated as a sale of assets. (Of course, the other problem is that the deal sometimes has already been agreed to before the donor talks to the charity.)

(2) *Charitable Bailout*. If there is no prearranged sale, a C corporation bailout is a common strategy. The donor donates some of the stock to charity (perhaps his children own the remaining stock), and in a non-prearranged transaction, the corporation redeems the charity's stock.

The first hurdle is getting over the prearranged redemption argument, which would treat the donor as having been redeemed and then contributing the proceeds to charity. *Palmer v. Commissioner* said the test is whether the foundation was legally obligated to redeem the stock when it received the shares. *See also* Rev. Rul. 78-197, PLRs 200321010, 200230004. The court in *Rauenhorst v. Commissioner* treated the IRS's position in Rev. Rul. 78-197 as a concession and strongly criticized the IRS for taking a position contrary to its then 25-year old published ruling.

If there is no prearrangement, the redemption can proceed for either a cash buyout or a note if the charity is not a private foundation. If the charity is a private foundation, and if the corporation is a disqualified person, the self-dealing rules apply, and the redemption can proceed only if the estate exception or corporate adjustment exception applies. A discussed above, a note cannot be used under the corporate adjustment exception. If the charitable contribution involves a bequest of the stock to a foundation, the probate exception may permit the redemption (if the redemption occurs while the estate still owns the stock), and a note can be used under the probate exception. PLRs 9312024, 9350038, 9112012, 0108024, 9042030. (These rulings approved redemptions for notes without discussing whether the subsequent note payments by the corporation would be self-dealing. Planners assume that the subsequent payments are permissible "and certainly that result is within the spirit of the rulings."

Assume that a business has redeemed a shareholder's interest in return for a note and that the shareholder dies owning the note but wants to leave it to charity. There is no problem if the charity is a public charity, but if the charity is a private foundation, and if the corporation is a disqualified person, the self-dealing rules come into play. Several rulings have allowed allocating a decedent's notes from a disqualified person to a foundation (PLRs 200729043 & 199924069), but the probate exception generally contemplates some transaction by an estate as opposed to a mere discretionary allocation. Some planners take little comfort in those rulings, especially in light of later rulings that authorize using an LLC in that circumstance (discussed in Item 12.i below).

(3) *Corporation Redemption Planning Opportunities*. Assume the client's children own 99% of the corporation (worth $10 million) and the client owns 1%. The client gives the 1% interest to charity. An income tax charitable deduction is allowed for the discounted value, (with say a 40% discount), or $60,000. The charity is not thrilled with owning the 1% interest, so it contacts the company about buying its interest. The company redeems the charity for the discounted value ($60,000). The children's wealth is increased by $40,000 as a result of buying the charity's interest at a discounted value. That seems totally plausible.

Push that. Assume the children own 51%, and the client owns 49% that is given to charity, which interest the appraiser values at $3 million (again, reflecting a 40% discount). The charity wants cash instead of stock in the closely held company. The corporation agrees to buy the charity's 49% interest for its appraised value of $3 million. The corporation borrows money to buy the charity's interest at its discounted value. The children now own all of the company with a net value of $7 million (i.e., $10 million less the $3 million note). The children's wealth has increased by $2 million (going from one-half of a $10 million company to all of a $7 million company).

What if the children own the 1% voting stock and the client gives its 99% non-voting interest to charity, appraised with a 30% discount. If the company buys the charity's stock at a 30% discount, the entire discount amount inures to increase the children's wealth. (Still, the client must have charitable intent for that to make sense.) Has that pushed the envelope too far?

i. **Using LLC for Conveying Existing Notes From Disqualified Person to Private Foundation Under Probate Exception**. A series of private letter rulings have offered increasingly

better alternatives of using LLCs for funding notes from a disqualified person to a foundation.

(1) *PLR 200635017*. In PLR 200635017, notes from family members were contributed to an LLC. The notes were contributed to single member LLC and the owner wanted to fund a charitable trust at his death with nonvoting units in the LLC. (The voting units would be left to the decedent's descendants.) Family members were granted options to purchase the notes or the nonvoting units in the LLC from the owner or his estate. The ruling concluded that if family members exercised their option rights to purchase the notes or the LLC, that transaction would come within the probate exception and would not be self dealing. More importantly, if the option is not exercised and the foundation continues to hold the nonvoting units in the LLC that owns the note from a disqualified person, the ruling reasons that even though the LLC and the family members who owe the note are disqualified persons, the foundation's retention of the nonvoting units in the LLC and its receipt of passive income from the LLC would not constitute acts of self-dealing. The ruling pointed out that the foundation would have no right to force distributions from the LLC, and that the timing and amount of any distributions from the LLC would be uncertain.

(2) *PLR 201407023*. PLR 201407023 opens the possibility of an owner selling a business to his children for a note, putting the note in an LLC, and leaving the LLC to the foundation. The note would be from a disqualified person (the deceased donor's children). The ruling quoted Reg. §53.4941(d)-2(c)'s statement that "except in the case of the receipt and holding of a note pursuant to a transaction described in §53.4941(d)-1(b)(3), an act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note." Therefore, leaving the note directly to a foundation would be an act of self-dealing. Even though the only asset of the LLC is the note from a disqualified person and the interest on the note will be the LLC's sole income, the ruling concludes that the distribution of nonvoting units in the LLC to a foundation at his death, and the continued retention of those nonvoting units, will not be an indirect act of self-dealing. The ruling does not rely on (or even mention) the probate exception but reasons that the foundation is merely receiving an interest in an LLC that holds a passive asset, not notes from a disqualified person, and emphasizes many distinctions between holding nonvoting units in the LLC and holding the note itself.

> Foundation's retention of a nonvoting interest in the LLC and its receipt of passive income from LLC, however, will not constitute any of the acts of self-dealing described in § 4941(d)(1) or § 53.4941(d)-2. The arrangement between the LLC and Foundation will neither be a loan nor an extension of credit. Section 53.4941(d)-2(c). Foundation would acquire nonvoting units in LLC by gift, rather than through a self-dealing transaction. As a holder of nonvoting units, Foundation will have a right to receive distributions only if LLC dissolves or it chooses to make current distributions, but the timing and amount of such distributions would be uncertain, and could not be compelled by Foundation. The Managing Members, holders of voting units, are given sole power to manage the affairs of LLC and determine the timing and amount of distributions. Additionally, Foundation cannot compel dissolution of LLC since it requires the vote of a holder of fifty percent of the voting units in addition to its own.

Foundation will not have "control" over LLC (as defined in § 53.4941(d)-1(b)(5)) due to the lack of voting power to manage or operate LLC. We do not consider the power associated with the non voting interest in LLC as a necessary party to vote on the liquidation of the LLC to be the equivalent of a "veto power" within the meaning of section 53.4941(d)-1(b)(5) in that the other attributes of that interest lack any other powers with respect to operation and management. Furthermore, the liquidation of LLC in this context could result in a self-dealing problem for Foundation. Therefore, the retention by LLC of your daughter's note following your death would not be an act of direct or indirect self-dealing between Foundation and one or more disqualified persons under § 53.4941(d)-(1) or § 4941.

(A companion ruling was issued to the foundation. PLR 201407021.)

(3) *PLR 201446024*. PLR 201446024 took this planning opportunity one step further—by having the estate create the LLC and contribute notes to the LLC before distributing nonvoting units in the LLC to a foundation. The decedent's estate owned a note from a disqualified person (from the lifetime sale of assets to an irrevocable trust created by the decedent). The notes had not been contributed to an LLC prior to the decedent's death. The estate proposed forming a single member LLC with voting and nonvoting units, contributing the notes to the LLC, and transferring nonvoting units in the LLC to a foundation. The ruling concluded that the exercise of the executor's power to contribute assets from the estate (specifically a note from a disqualified person) to a wholly owned LLC, the receipt of consideration by the estate of voting and non-voting units in the LLC, the subsequent sale of voting rights for cash equal to fair market value, and the distribution of non-voting units and cash from estate through a revocable trust to a foundation, will satisfy the probate exception to the self-dealing rules and will not constitute impermissible acts of self-dealing under §4941.

Because the probate exception was being used to allow the notes from disqualified persons to pass to the private foundation (and because various prior rulings have authorized the direct transfer of notes from disqualified persons to private foundations under the probate exception), one wonders why the "LLC wrapper" was used as well:

"…there are many IRS rulings simply allowing the note [from a disqualified person] to be transferred to the private foundation, and principal and interest payments to be made thereunder, under the estate administration exception. Here, however, the note was not transferred directly to the private foundation (as would otherwise have been permissible), but was transferred to an LLC that was not controlled by the foundation and was not a disqualified person, rather than the note being distributed directly to the private foundation. The taxpayer in this ruling presumably felt more comfortable interposing a non-controlled entity and a non-disqualified person between the private foundation and the disqualified person obligated on the note or may have done so for management purposes, although IRS rulings would indicate that this was not necessary to fall under the estate administration exception. Richard Fox & Jonathan Blattmachr, *Avoid Unintentional Self-Dealing With Private Foundations,* 42 EST. PLANNING 2, 11 (August 2015).

(4) *Example Application of LLC Wrapper Strategy to Business Interests.* Assume that a taxpayer owns an office building and wants her son to manage the building, but wants to give the building to a private foundation. The foundation cannot lease the building to the children or negotiate a long-term management contract with the son. The taxpayer might complete the management contract, and contribute the building (subject to the management contract) to a wholly owned LLC. Donating the nonvoting units to a foundation during the taxpayer's lifetime *may* be treated as an

indirect act of self dealing (but the transfer of nonvoting units in the LLC *may not* be treated as an indirect act of self-dealing under the reasoning of PLR 201407023, discussed above). If, however, the contribution of the building to the LLC and sale of voting units to the son and distribution of nonvoting units to the LLC were all approved by a probate court, could this transaction satisfy the probate exception? (A distinction from the rulings described above is that the LLC may be operating a business, which would raise excess business holdings issues, as compared to using an LLC merely to hold notes from a disqualified person.)

j. **Charitable Gifts of Partnership or LLC Interests**.

(1) *Donor Issues*. A charitable gift of a partnership interest may result in phantom ordinary income to the donor if the partnership has unrealized receivables or appreciated inventory or if there is any investment tax credit subject to recapture. §§47-50, 751(a). The gift could also accelerate any unrecognized installment gain in the partnership. Rev. Rul. 60-352.

If the partnership has outstanding indebtedness, the donor may be treated as having received payment for his or her share of the partnership liabilities that are relieved, resulting in phantom capital gain income to the donor. §752.

A gift of a partnership interest is treated as a gift of a capital asset, so a gift to a public charity would qualify for a deduction based on the full fair market value of the interest (but it may be subject to discounts).

The same prearranged sale principles that apply to corporate redemptions might also apply to gifts and subsequent redemptions of partnership interests.

(2) *Charitable Donee Issues*. A tax exempt organization pays tax on its unrelated business taxable income (UBTI). UBTI includes income from trade or business activities that are substantially unrelated to the organization's purposes. §512. Passive income does not generally constitute UBTI (§512(b)), unless the income results from debt-financing. If property that produces passive income is financed by acquisition indebtedness, the proportionate part of the gross income (including capital gain) is UBTI. §514(b). (The ratio for determining that proportionate part is the ratio of the average acquisition indebtedness to the average adjusted basis in the property during the year.) If the charity would pay a higher tax than the taxpayer on a sale of donated property, the donor may prefer to sell the property directly, and contribute the after-tax proceeds to charity in order to get more value to the charity.

If the partnership is producing UBTI, the charity will want assurances that the partnership will make "tax distributions" to its partners so that the charity will receive cash flow to pay its income tax on partnership income.

The charity will likely also want assurances that it will not be called upon to make future capital contributions to the partnership.

(3) *Charitable Partnership Planning Opportunities*. A client owns $10 million of a concentrated stock portfolio. The client might contribute $10 million to a partnership for a 98% LP and 1% GP interest, and a trust for children contributes enough to own a 1% LP interest. The client gives the 98% LP interest to charity.

The partnership sells the concentrated stock portfolio. The K-1 will reflect that 98% of the capital gain is allocated to the charity (on which it owes no income tax). Later, the family might buy the charity's 98% LP interest for FMV (say $10 million discounted by 30%, or $7 million). Now the family owns a $10 million company, for which it only had to pay $7 million. The client still must have charitable intent for this to make sense—the family is paying charity $7 million. But if, for example, the client wants to satisfy a big charitable pledge a transaction like this could accomplish the charitable gift goal and also accomplish a wealth shift to a trust for the client's children at the same time.

The charitable partnership was examined by the IRS National Office in 1999 and it passed muster, as long as everything is done on an arm's length basis.

k. **Charitable Gifts of S Corporation Stock**.

(1) *Exempt Organizations Can be S Corporation Shareholders*. Prior to 1998, a charitable organization was not a qualified S corporation shareholder. Charities are now qualified shareholders (§§1361(b)(1)(B) and (c)(6)), but CRTs and pooled income funds are still disqualified shareholders (they cannot qualify under the grantor trust, QSST or ESBT rules).

(2) *All Income is UBTI*. There are not many charitable gifts of S corporation stock. A significant disadvantage is that the charity is taxed on *all* of the flow-through income of the S corporation as UBTI. §512(e). (This is contrasted to partnership interests owned by charities—only the flow-through income from partnerships that is attributable to UBTI activities is treated as UBTI to the chartable partner.) Further, capital gain realized on the sale of S corporation stock is also UBTI. §512(e)(1)(B)(ii).

(3) *Using Supporting Organization to Reduce Charity's UBTI Tax Cost.* A strategy of reducing the UBTI tax cost to the charity is to have the S corporation stock held in a supporting organization (SO) for the organization. A corporate SO is entitled to a charitable deduction up to 10% of the UBTI, effectively reducing the tax cost by 10%. A trust SO is entitled to a charitable deduction for UBTI like individuals—thus generally qualifying for a 50% deduction if the SO supports a public charity, effectively cutting the tax cost by 50%. §512(b)(11).

(4) *Excess Business Holdings*. Private foundations often may not hold S corporation stock because of the excess business holdings rule.

(5) *Excellent Resource*. For an excellent resource addressing the effects of charitable gifts of S corporation stock, see Christopher R. Hoyt, *Charitable Gifts by S Corporations and Their Shareholders: Two Worlds of Law Collide*, 36 ACTEC L.J. 693 (Spring 2011).

l. **Charitable Gifts by Business Entities**. Charitable gifts by business entities can be a particularly effective strategy for gifts of highly appreciated, underproductive assets. The gift can be made directly to a charitable organization or to a CRT with a retained term-of-years interest for the business entity.

(1) *C Corporations*. C corporations only receive a charitable deduction up to 10% of taxable income.

(2) *C Corporation Maxed Out on Charitable Deductions*. If a C corporation would like to contribute more to charity than it can deduct under the 10% limitation, PLR 200715015 offers a planning strategy. A corporation formed a limited partnership (the other partner was the owner of the corporation), contributed some of its intellectual property to the partnership, entered into a license agreement to use the intellectual property in return for royalty payments to the partnership, and contributed the limited partnership units to a private foundation (created and managed by the owner). Because the partnership received 95% or more of its income from passive sources (*i.e.*, royalties), it was not an excess business holding and the royalty flow-through income was not UBTI to the foundation (passive income is not UBTI unless it is generated by debt-financed property). The corporation would receive a 100% deduction for the royalty payments to the partnership and the royalty payments were not taxable income to the foundation—effectively having the benefit of a deduction for the additional value passing to the foundation.

(3) *S Corporations*. Following the Subchapter S Revision Act of 1982, charitable contributions by S corporations are deductible proportionately by the shareholders (§1366(a)(1)), but a shareholder's deduction is limited to the shareholder's basis in the S corporation stock and any corporate indebtedness to the shareholder. §1366(d)(1). For an excellent discussion of the complexities of charitable gifts by S corporations, see Christopher R. Hoyt, *Charitable Gifts Made by S Corporations: Opportunities and Challenges,* 36 ACTEC L.J. 477 (Winter 2010).

A shareholder's basis in its S corporation stock is generally reduced by any deductions passing through to the shareholder, but §1367(a)(2) stated that the shareholder's basis would be reduced only by the shareholder's pro rata share of the basis of the contributed property. This was a huge benefit to S corporation shareholders. The §1367(a)(2) favorable provision expired after 2013, but was extended to the end of 2014 by the "tax extenders" legislation enacted in the last several weeks of 2014. We will see if it gets extended again.

If an S corporation that converted from a C corporation within the last 10 years wishes to sell appreciated property subject to the built-in gains tax of §1374, the built-in gains tax can be avoided by contributing the property to a charitable remainder unitrust. PLR 200644013 (no built-in gain recognition upon the contribution to the CRT or the trust's sale of the property within the 10-year recognition period).

(4) *Section 337*. Corporations making large charitable contributions must be careful to avoid §337. Regulations to §337 provide that a taxable corporation is required to recognize gain or loss upon the transfer of "all or substantially all of its assets to one or more tax-exempt entities." Reg. §1.337(d)-4(a)(1).

(5) *Partnerships and LLCs*. Similarly, gifts by partnerships or LLCs are deductible proportionately by the partners or members. §702(a)(4). The partner may deduct his or her share of the charitable contribution without regard to the partner's basis, but the partner must reduce its basis in the partnership to the extent of the partnership's basis in the property contributed. Rev. Rul. 96-11.

Rev. Rul. 2004-5 provides that a trust that is a partner is entitled to a charitable deduction for the trust's distributive share of the charitable gift from the

partnership's gross income—even if the trust has no charitable beneficiaries. The deduction is not disallowed under §642(c) "merely because the trust's governing instrument does not authorize the trustees to make charitable contributions." The key to receive a charitable deduction for a trust under §642(c) is that the contribution must be from income. Similarly, the contribution from the partnership must be from partnership income in order for the trust to use the charitable deduction.

The Revenue Ruling does not address how the trust came to be a partner. Is there a limitation if the trust invests assets in an investment partnership as a way of being able to allow indirect transfers to charity with the trust receiving a charitable deduction—even though the trust instrument does not allow charitable distributions? There is no such limitation suggested in the Revenue Ruling. (A possible strategy may be to have the trust make the investment in an investment partnership and make some small charitable gifts for several years and see if the IRS objects.)

m. **Charitable Lead Trust Planning Strategies**.

(1) *Backloaded CLT to Accumulate Funds for Private Foundation And Delay Requirement of Making 5% Annual Distributions*. Backloading of charitable lead trusts appears permissible. There is no explicit requirement that the charitable lead payments be uniform or only be graduated up to a certain maximum amount. The CLT could be structured so that relatively low charitable payments are made in early years. This would result in a delay of actual payments to a private foundation, thus delaying the time that the foundation must begin making 5% annual distributions. *See* Notice 2004-36 & Notice 2004-35. The CLT assts would likely be invested during this period with assets that do not generate substantial taxable income, because the trust would receive no current charitable deductions beyond the charitable payments that are actually made each year from the trust.

For an excellent discussion of backloaded CLTs, see Paul S. Lee, Turney P. Berry & Martin Hall, *Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhorse*, 37 ACTEC L.J. 93 (Summer 2011).

(2) *Transfer "Excess" Future Appreciation/Income to Family*. The economics of a charitable lead annuity trust (CLAT) work much the same as for a GRAT, except that the lead payments during the term of the trust are made to charity rather than to the grantor. If the assets produce combined appreciation/income in excess of the §7520 rate (2.0% for April 2015), the excess ultimately inures to the benefit of the family members who are the remaindermen at the end of the CLAT term.

An alternate way of thinking about a CLAT is that a client may want to leave a specific amount (say $1 million) to the Red Cross at the client's death. The client is thinking that will be in 20 years. If the client dies early, does the client want the Red Cross still to receive the same $1 million (which has a much larger present value than the client was originally thinking). An alternative, in case the client dies early, is to use a testamentary lead trust. The Red Cross would still start receiving payments after the client's death (although a backloaded CLAT could be used), but the excess appreciation/income in excess of the §7520 rate would be building up for the family's ultimate use.

(3) *Transferring Business Interest Using a CLAT*. A client might sell his business interest (perhaps to children). The note that the client receives for selling the business that is still owned at the client's death could be left to charity or could be left to a CLAT. This type of transaction was approved in PLR 200124029. The contribution of the note to the CLAT was approved within the probate exception to the self-dealing rule. A disadvantage of this approach is the loss of the basis step-up before the business interest is sold.

Alternatively, the client might give his children an option to purchase the business from his estate following his death. The client's will might leave the business interest (subject to the purchase option) to a testamentary CLAT. The children might exercise the option to purchase the interest from the estate in return for a long-term note. The sale by the estate would generate little taxable gains because of the basis step-up. The note would then pass to the CLAT.

As discussed above, a CLT is subject to the self-dealing rules for private foundations. The client's children would be disqualified persons, so their purchase of the stock that is bequeathed to the CLT would be a prohibited self-dealing transaction, *except* that the purchase from the estate will be approved by a court and will be structured to satisfy the probate exception to the self-dealing rules (discussed in Item 12.e above). The note payments may be structured so that the interest and principal payments would be sufficient to satisfy the charitable lead annuity payments from the CLAT. Taking into consideration valuation discounts when the children purchase the business interest from the estate, the interest payments on the note (and perhaps small principal payments as well) may be sufficient to fund the charitable annuity payments. The children would own the business; the CLAT would be structured to generate a 100% estate tax charitable deduction so that no estate tax is paid with respect to the value of the business interest; the children would be able to fund the annuity payments with distributions from the business; and the payments could fund a family foundation. (If the children are making charitable gifts in any event, the CLAT charitable payments may replace their charitable gifts during the term of the trust.)

Turney Berry cynically observes a problem with this plan—it is so favorable that family members will want the patriarch/matriarch to die now while the interest rates are low. "We encourage our older clients not to get flu shots."

For an outstanding resource discussing the planning opportunities and technical challenges of transferring business interests using testamentary CLATS, see Richard Franklin & Jennifer Goode, *The Intermediary CLAT Alternative to the Residuary Estate Family Foundation Gift*, 39 ACTEC L.J. 355 (Winter 2013).

APPENDIX A

FLP/LLC Discount Table of Recent Cases (prepared by John Porter, Houston, Texas)

Case	Assets	Court	Discount from NAV/Proportionate Entity Value
Strangi I	securities	Tax	31%
Knight	securities/real estate	Tax	15%
Jones	real estate	Tax	8%; 44%
Dailey	securities	Tax	40%
Adams	securities/real estate/minerals	Fed. Dist.	54%
Church	securities/real estate	Fed. Dist.	63%
McCord	securities/real estate	Tax	32%
Lappo	securities/real estate	Tax	35.4%
Peracchio	securities	Tax	29.5%
Deputy	boat company	Tax	30%
Green	bank stock	Tax	46%
Thompson	publishing company	Tax	40.5%
Kelley	cash	Tax	32%
Temple	marketable securities	Fed. Dist.	21.25%
Temple	ranch	Fed. Dist.	38%
Temple	winery	Fed. Dist.	60%
Astleford	real estate	Tax	30% (GP); 36% (LP)
Holman	dell stock	Tax	22.5%
Keller	securities	Fed. Dist.	47.5%
Murphy	securities/real estate	Fed. Dist.	41%
Pierre II	securities	Tax	35.6%
Levy	Undeveloped real estate	Fed. Dist. (jury)	0 (valued at actual sales proceeds with no discount)
Giustina	Timberland; forestry	Tax	25% with respect to cash flow valuation (75% weighting to cash flow factor and 25% weighting to asset method)
Gallagher	publishing company	Tax	47%
Koons	Cash	Tax	7.5%